IN THE

Supreme Court of the United States

OCTOBER TERM, 1965

No. 23

FRIBOURG NAVIGATION COMPANY, INC.,
Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

ON WRIT OF CERTIORARI TO THE UNITED STATES
COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR THE PETITIONER

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Opinions Below

The opinion of the Court of Appeals (R. 76-82), Judge Moore dissenting (R. 82-90), is reported at 335 F. 2d 15 (2d Cir. 1964). The memorandum opinion of the Tax Court (R. 2-18), T. C. Memo. 1962-290, is not officially reported, but is unofficially reported at 21 CCH T. C. Memo. 1533 (1962) and at 1962 P-H T. C. Memo. ¶ 62,290.

Jurisdiction

The judgment of the Court of Appeals was entered on July 15, 1964. (R. 91.) An order of the Court of Appeals denying a timely petition for rehearing and granting a timely motion to stay issuance of its mandate was entered on August 20, 1964. (R. 99-100.) The petition for a writ of certiorari was filed on November 13, 1964, and was granted on February 1, 1965. (R. 102.) The jurisdiction of this Court is invoked under 28 U. S. C. § 1254(1).

Statute and Regulations Involved

The statute and regulations involved are section 167 of the Internal Revenue Code of 1954, 26 U. S. C. § 167, and Treasury Regulations sections 1.167(a)-1 through 1.167(i)-1, 26 C. F. R. §§ 1.167(a)-1 through 1.167(i)-1. The pertinent portions of the statute and regulations are set forth in Appendix A, *infra* pp. 1a-11a.

Question Presented

Whether, as a matter of law, the sale of depreciable property for an amount in excess of its depreciated cost at the beginning of the year of sale necessarily bars the deduction of depreciation on the property for the period of its use during that year.

Statement of the Case

The facts of this case are not in dispute. Petitioner, a Delaware corporation organized in 1946, was engaged during and prior to 1957 in the business of owning and operating ships for charter to others for the carriage of dry, bulk cargoes in foreign commerce. (R. 3, 19.) On December 21, 1955, petitioner purchased the *S.S. Joseph Feuer* (the "*Feuer*"), a Liberty-type dry cargo ship, from an unrelated party for $469,000. (R. 4, 20.) The *Feuer* had been built during 1943, under an accelerated ship-building program, for emergency use during World War II. (R. 4, 49.)

Liberty-type ships had a speed of only 10 knots, old-fashioned engines, inefficient cargo loading and discharging equipment, and a low ratio of cubic capacity to dead weight. (R. 8, 49-50.) They were greatly inferior to modern, postwar cargo ships, which had a speed of 14 to 18 knots, turbine engines, better cargo handling facilities and a much larger cubic capacity. (R. 8, 49-50.) In postwar com-

merce, Liberty-type ships were reduced principally to the shipment of low-paying bulk commodities, primarily grain and coal. (R. 8-11, 50.)

The *Feuer* as an American flag ship was unable, because of higher operating costs, to compete with foreign flag vessels in general commerce. (R. 31.) The only cargoes it could economically carry were the bulk commodities shipped abroad under United States foreign aid legislation, which gave American flag vessels a preferred status. (R. 31-34.) On completion of such shipments the *Feuer* returned to the United States in ballast because rates for return cargoes were too low to permit it to operate profitably. (R. 31-32, 35.) Petitioner was prohibited by law from transferring the *Feuer* to a foreign flag. (R. 31.)

Petitioner operated the *Feuer* under the American flag as a tramp ship, for charter wherever cargo was offered. (R. 7, 20, 28.) It operated the *Feuer* under six voyage charters for shipment of grain, sugar, fertilizer or scrap iron from the United States or Cuba to Korea, Japan, Morocco, Egypt, Israel or India, and also operated it under time charter for about nine months. (R. 7, 20-21.)

In the fall of 1956, following the outbreak of hostilities, the Suez Canal was blocked by sunken vessels and was not reopened for full-time use, under Egyptian management, until March 29, 1957. (R. 5.) Because of the blockage of the Suez Canal, which is the busiest interocean canal in the world, ships had to take longer routes to places usually reached by going through the Canal. (R. 5.) There was a resulting scarcity of available ships to carry cargoes. (R. 5.) European governments, anticipating a long delay in the opening of the Canal, began stockpiling oil and other commodities. (R. 5.) There were resulting increases in charter rates, which reached a peak in January and February of 1957. (R. 5.) During this brief crisis the opera-

tion of any type of ocean-going vessel, including American flag Liberty-type ships, became profitable. (R. 5, 57.) The temporary scarcity of ships caused sales prices of ships to rise sharply. (R. 5.) In January and February of 1957, purchasers were willing to pay $1,000,000 for American flag Liberty-type ships. (R. 5.)

Petitioner did not follow a practice of buying ships and then selling them after a short period of use. (R. 6.) However, in June of 1957, the president of Isbrandtsen Company, Inc. ("Isbrandtsen") approached petitioner about the possible purchase of the *Feuer*. (R. 6.) Isbrandtsen, like petitioner, was engaged in the business of using Liberty-type ships as tramp carriers of grain and other bulk commodities. (R. 6, 52.) Petitioner had not put the *Feuer* up for sale, but Isbrandtsen offered such an excellent price for the *Feuer* that petitioner decided to sell it. (R. 6.) On June 14, 1957, petitioner entered into a contract for the sale of the *Feuer* to Isbrandtsen in December of that year for $700,000. (R. 6.) At the closing on December 23, 1957, the sales price was reduced to $695,500 in connection with a change in financing. (R. 6.)

Prior to the sale petitioner adopted a plan of complete liquidation, which it completed within 12 months in accordance with section 337 of the Internal Revenue Code. (R. 7.) Petitioner owned and operated another ship, the *Flying Foam,* which it distributed in kind in the complete liquidation. (R. 6, 7.)

By December of 1957, when petitioner delivered the *Feuer* to Isbrandtsen, charter rates had fallen sharply from the high levels they had reached during the Suez crisis. (R. 8.) This drop in rates resulted from the reopening of the Suez Canal, the diminishing of world tension, the entry into the market of large modern vessels and the realization by the European governments that they had overstocked commodities. (R. 8.) By the end of 1957, the eco-

nomic position of the remaining American flag Liberty-type ships had deteriorated substantially. (R. 8-11.) Charter rates for American flag Liberty-type ships were significantly lower than they had been in the last quarter of 1955 when petitioner had purchased the *Feuer*. (R. 9.) This decline in charter rates brought about a corresponding decline in prices of Liberty-type ships, which by December 1957 had fallen to the level of $400,000 to $500,000. (R. 11.)

The business of shipping coal, which had been one of the two principal commodities carried by American flag Liberty-type ships, had largely disappeared by the end of 1957 because of the world-wide increase in oil consumption. (R. 10.) At the same time, the trade in heavy grain, which was the last important commodity carried by the American flag Liberty-type ships, was beginning to be captured by faster and larger converted tankers, which were able to carry grain at much lower rates. (R. 8, 10.) During the Suez crisis the United States Government had encouraged the building of American flag tankers by providing extensive financing guarantees. (R. 10.) During 1957, nineteen American flag tankers having a total dead weight tonnage of 731,273 tons (about equal to the total dead weight tonnage of the 70 or so Liberty-type ships operating as tramp vessels under the American flag) were contracted for or under construction. (R. 10.) These tankers had speeds of about 15½ to 16 knots, much faster than the Liberty-type ships. (R. 10.) During the Suez crisis, when these tankers were ordered, the charter rates for oil were high and remunerative. (R. 10.) However, by the end of 1957 this was no longer true, and the surplus American flag tankers had begun to be converted to the shipment of grain in competition with Liberty-type ships. (R. 10.)

In December 1957 the United States Maritime Administration sold several Liberty-type ships for scrapping

under a previously extended invitation for bids. (R. 11.) The price obtainable for Liberty-type ships for scrapping is determined principally by reference to the price of No. 1 scrap steel, and the cost of preparation, towing, insurance, and other costs of scrapping. (R. 11.) A buyer for scrapping is influenced by the estimated future of the scrap steel market because of the time required to prepare and sell the scrap steel. (R. 11.) In December of 1957, scrap steel prices were falling. (R. 11.) The amount which a buyer could be expected to offer for a Liberty-type ship for scrapping at that time was between $53,000 and $60,000. (R. 11.)

Before buying the *Feuer* (then named the *S. S. Albion*), petitioner applied for a ruling from the Engineering and Valuation Branch of the Internal Revenue Service with respect to depreciation of the ship. (R. 4, 20.) The Internal Revenue Service ruled, by letter dated December 8, 1955, that it would accept for the *Feuer* a useful economic life of three years from the date of acquisition and a salvage value computed on the basis of $5 per dead weight ton ($54,000). (R. 4; Ex. 4-D, R. 22, 24-25.) The ruling also stated that the cost of $469,000, less such salvage value, should be spread ratably over such three-year period; that the cost would be subject to verification; that the estimated remaining useful life was subject to such change as subsequent experience might warrant; and that the ruling was not to be construed as a binding agreement as to useful life within section 167(d) of the Internal Revenue Code. (R. 4; Ex. 4-D, R. 22, 24-25.)

Acting in accordance with the ruling, petitioner computed depreciation of the *Feuer* on the basis of $415,000 ($469,000 cost less $54,000 salvage value), which it spread over a three-year useful life from December 21, 1955, under the straight-line method. (R. 4.) This resulted in deprecia-

tion at a daily rate of about $378.65. (R. 4.) Petitioner claimed the following depreciation deductions at such rate and under such method, as authorized by the ruling, on its income tax returns (R. 22):

Calendar Year	Period of Ownership	Depreciation Claimed
1955	10 days	$ 3,786.50
1956	366 days	138,585.77
1957	357½ days	135,367.24
	Total	$277,739.51

Petitioner's income tax returns for each of the years 1955 to 1957 were audited by the Internal Revenue Service. (R. 22.) The deductions claimed by petitioner for depreciation of the *Feuer* on the 1955 and 1956 returns were accepted by the Service without adjustment. (R. 5.) The depreciated cost of the *Feuer* as of the beginning of 1957 was $326,627.73. (R. 5.)

On its 1957 income tax return, petitioner reported gross income (after direct cost of operations) of $391,811.31, of which about $289,340 represented gross profit from the operation of the *Feuer*. (R. 7.) After deductions of $250,617.96, including $135,367.24 for depreciation of the *Feuer*, petitioner reported taxable income of $141,193.35. (R. 7.) The reported taxable income did not include the gain from the sale of the *Feuer*, which was nontaxable under section 337 of the Internal Revenue Code, but petitioner disclosed that gain on an information schedule. (R. 7.)

On audit of the 1957 return, respondent did not change the ruling of December 8, 1955, relating to useful economic life and salvage value of the *Feuer* (R. 5), and did not question the original estimate of a three-year useful

economic life for the *Feuer* in petitioner's business. (R. 14.) Nevertheless, respondent wholly disallowed the deduction for depreciation of the *Feuer* on the ground that petitioner "was not entitled to depreciation * * * under the applicable provisions of the Internal Revenue Code of 1954." (R. 7.)

The Tax Court sustained the disallowance of the 1957 depreciation deduction for the *Feuer*. (R. 18.) The Court of Appeals for the Second Circuit, Judge Moore dissenting (R. 82-90), affirmed the decision of the Tax Court. (R. 7[illegible]2.)

Summary of Argument

For over 40 years prior to the trial of this case, administrative, judicial, legislative and accounting authorities consistently and unanimously held that depreciation is allowable on property up to the date of sale, whether or not the sale is at a profit. Shortly before the trial of this case in 1962, the Commissioner of Internal Revenue decided to reject this long settled rule. Almost alone among the ten courts that have considered the Commissioner's new position, the Second Circuit in the decision below sustained it.

The disallowance of depreciation in the year of profitable sale violates the depreciation accounting practice that this Court has long held to be applicable for income tax purposes. Under that accounting practice the useful life and salvage value of the property are estimated at the time of its acquisition, and cost less salvage value is written off by a consistent method over the useful life. Salvage value under this practice may not be changed because of subsequent increases in price levels, whether or not realized by sale. To obtain a fair reflection of net income from operations, depreciation must be subtracted from gross operating income for the year of sale—whether the sale be at a profit or loss—and the profit or loss on the sale must be reflected in a nonoperating account. Any other rule would

distort both operating income and gain or loss on the sale. (Pp. 12-18, *infra.*)

From the enactment of the modern income tax until shortly before he announced his present view in 1962, the Commissioner regularly allowed depreciation in the year of profitable sale. His practice is shown in numerous decisions of this Court and lower courts extending from 1921 through 1960, in all of which the Commissioner had allowed depreciation straight through to the date of sale. A series of early rulings reflect the same practice. In the few cases where taxpayers questioned the Commissioner's practice, the courts squarely held that depreciation should be allowed for the year of sale, regardless of whether the sale produced a profit or a loss. In the one case in which the Commissioner put the question in issue by disallowing depreciation for the year of profitable sale, the Tax Court held in 1947 that the depreciation was allowable and the Commissioner, by promptly acquiescing in the decision, showed that he agreed. The accounting principle that year-of-sale depreciation was allowable thus became generally accepted, and was embodied in the Treasury's income tax regulations. (Pp. 18-29, *infra.*)

Congress repeatedly reenacted the statutory depreciation provision without relevant change, with knowledge that depreciation was deductible for the year of profitable sale. Congress even gave an example of such a deduction in its committee reports on the Revenue Act of 1950. In view of the close supervision of the statute by Congress and its knowledge of the precedents establishing that year-of-sale depreciation was allowable, its repeated reenactment of the statute must be deemed to have given those precedents the effect of law. (Pp. 29-41, *infra.*)

The Commissioner grounds his sudden abandonment of this long and well settled rule on the Sixth Circuit's 1958

decision in *Cohn* v. *United States, infra,* which the Commissioner contends held that depreciation for the year of profitable sale must be disallowed as a matter of law. To read the *Cohn* decision as the Commissioner has read it would make that decision violate every depreciation precedent. By 1958 the deductibility of year-of-sale depreciation had become too well established to be overturned by judicial fiat. (Pp. 46-48, *infra.*)

Furthermore, the briefs and opinion in the *Cohn* case show conclusively that the Sixth Circuit was not asked to hold, and did not hold, that depreciation for the year of profitable sale is barred as a matter of law. The Government argued on brief in the *Cohn* case that the district court had not based its determination of salvage value on sales price alone, but had made a factual determination on the basis of all the circumstances. Accepting this argument, the Sixth Circuit sustained the district court's finding of fact with respect to salvage value as not clearly erroneous. This narrow factual affirmance did not establish the broad rule of law the Commissioner is urging here. (Pp. 41-45, *infra.*)

The *Cohn* case is inapplicable here for the further reason that the sale of property in that case was made at or near the end of its useful life. In the present case the taxpayer sold the *Feuer* in the middle of its predictable useful life on receiving an unexpected offer of an attractive price from a competitor during the Suez Canal crisis. Since salvage value is the value of property at the end of its useful life, the price received on an unanticipated sale of property in the middle of its useful life does not establish its salvage value. (Pp. 45, 50, 52, *infra.*)

The Commissioner's recent decision to ignore both logic and history has been disapproved by the Eighth Circuit, the Tax Court and six of the seven District Courts that have considered it. The Tax Court, after temporarily embracing

the Commissioner's novel doctrine in an inadequately briefed case and then following it in the present case, recently repudiated it in a well-reasoned decision reviewed by the entire court. (Pp. 48-53, *infra.*)

The Commissioner's doctrine that any profitable sale of depreciable property bars depreciation for the year of sale—regardless of the reasonableness of the estimates of useful life and salvage value, the time during useful life at which the sale occurs, and the circumstances under which the sale occurs—should, therefore, be disapproved.

The decision below should be reversed without remand for further findings. The Tax Court's findings clearly establish that the taxpayer has proved the reasonableness of the depreciation deduction claimed by it. The deduction was computed under a useful life and salvage value established by a ruling obtained from the Commissioner when the ship was purchased in December of 1955. The Commissioner has never questioned the correctness of this determination of useful life and salvage value, and their correctness has been confirmed by extensive evidence presented to the Tax Court. The taxpayer has established that it is entitled to the reasonable allowance for depreciation claimed by it. (Pp. 53-55, *infra.*)

ARGUMENT

This case arises from an attempt of the Commissioner of Internal Revenue to reverse the interpretation long given to the income tax provision, now section 167(a) of the Internal Revenue Code, authorizing "as a depreciation deduction a reasonable allowance for the exhaustion, wear and tear (including a reasonable allowance for obsolescence) . . . of property used in the trade or business."

The parties agree that the components of the depreciation formula are the cost, salvage value and useful life of the property; that the accepted formula calls for cost less estimated salvage value to be written off by some consistent method over the estimated useful life; and that the property may not be depreciated below such salvage value. The dispute is over the deductibility of depreciation for the year of sale of the depreciable property at a profit. The petitioner-taxpayer contends that it is entitled to deduct depreciation up to the date of sale under the above formula and reasonable estimates of useful life and salvage value. The Commissioner of Internal Revenue disagrees. This disagreement is significant because depreciation deductions are subtracted from income taxable at ordinary rates; and, although the depreciation taken also reduces the basis of the property and thus increases the gain on its sale, that gain is usually taxed at the lower capital gains rate or, if a nonrecognition provision applies, is not taxed.[1]

I. Depreciation of Property for the Year of Its Profitable Sale Is Necessary To Reflect Income Clearly and Is Required by Sound Business Accounting Principles Approved by this Court for Income Tax Purposes.

Allowance for the exhaustion, wear and tear and obsolescence of business property for the year of its profitable sale is essential to a correct reflection of income from operations and to a correct reflection of gain or loss on the sale. This is one of the established rules of business depreciation accounting, the principles of which this Court has long recognized to govern tax depreciation.

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[1]Petitioner's gain on sale of the *Feuer* was not recognized by reason of the application of section 337 of the Internal Revenue Code. (R. 7, 78.)

The income tax statute authorizes deduction of depreciation as "charged in practical bookkeeping." *Stratton's Independence, Ltd.* v. *Howbert,* 231 U. S. 399, 423 (1913); *Von Baumbach* v. *Sargent Land Co.,* 242 U. S. 503, 524 (1917).[2] In response to the question "What was here meant by 'depreciation of property'?", this Court stated in the latter case: "We think Congress used the expression in its ordinary and usual sense as understood by business men." 242 U. S. at 524. In *United States* v. *Ludey,* 274 U. S. 295, 300-301 (1927), this Court applied for income tax purposes what Mr. Justice Brandeis, the author of the opinion, later called the "business men's practice" of depreciation.[3] The connotations of this income tax deduction, this Court more recently observed, are those of "accounting and engineering terminology." *Real Estate-Land Title & Trust Co.* v. *United States,* 309 U. S. 13, 16 (1940).

Depreciation accounting for business purposes is a process of cost allocation.[4] It aims to distribute the cost of business property, less its salvage value (if any), over its useful life in the business.[5] This accounting formula for depreciation was adopted by this Court for income tax purposes in *United States* v. *Ludey, supra.* The measure of the annual deduction, said Mr. Justice Brandeis for the Court, "is the sum which should be set aside for the taxable year, in order that, at the end of the useful life of the plant in the business, the aggregate of the sums set aside will (with

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[2]These cases arose under the depreciation provision of the Corporation Excise Tax Act of 1909, which was the direct predecessor of the depreciation provision for corporate taxpayers in the Revenue Act of 1913. Both such provisions are reproduced in Appendix B, *infra* pp. 1b-3b.

[3]Dissenting opinion in *United Railways and Electric Co.* v. *West,* 280 U. S. 234, 274 (1930).

[4]American Inst. of Accountants, Committee on Terminology, Accounting Terminology Bulletin No. 1, § 56 (1953).

[5]*Ibid*; Saliers, Depreciation Principles and Applications 159 (3d Ed. 1939).

the salvage value) suffice to provide an amount equal to the original cost." 274 U. S. at 300-301.

Cost is a known factor in the computation of depreciation, but useful life and salvage value must usually be estimated.[6] Inadequate or excessive depreciation resulting from erroneous estimates may be checked by periodic revision.[7] The estimate of useful life, and thus the depreciation rate, is subject to prospective correction on clear evidence;[8] and, since salvage value is the expected value at the end of useful life, revision of useful life may also require revision of salvage value.

Salvage value may not, however, be changed because of changes in price levels or market values. The fact that the property has appreciated in value furnishes no reason to adjust depreciation.[9] Revision of salvage value to reflect changing price levels "violates the basic concept of depreciation accounting because it does not fairly allocate the cost of depreciable property to income over its useful life."[10]

The rule that salvage value may not be changed to reflect changes in price levels applies not only to unrealized increase or decrease in value, but also to changes in price level realized by sale or other disposition of the property. The profit or loss upon retirement of the property is reflected in a "special profit or special loss account" rather than in the depreciation account, so that it "can be excluded

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[6]Saliers, *op. cit. supra* 130; Montgomery, Auditing 271 (8th Ed. 1957).

[7]Braunstein and Johnson, *Public Utility Depreciation and the Income Tax*, 52 Harv. L. Rev. 1077, 1087 (1939).

[8]Montgomery, *op. cit. supra* 271; Paton, Accountants' Handbook 729, 771 (3d Ed. 1943).

[9]Saliers, *op. cit. supra* 46, 135, 172-173; Montgomery, *op. cit. supra* 269; Paton, *op. cit. supra* 717, 718.

[10]Montgomery, *op. cit. supra* 273; Saliers, *op. cit. supra* 61, 68-69; 1 Dewing, The Financial Policy of Corporations 537, note f (5th Ed. 1953).

from the current expense and revenue data."[11] A loss from casualty, being in the nature of a capital loss, is likewise written off against surplus instead of being added to depreciation.[12] A sale is treated for this purpose exactly like any other retirement: "[t]he amount in the depreciation allowance applicable to the particular unit retired should be charged off, and the balance should be treated as a special profit . . . item."[13] If, for example, a retirement is made on September 15, depreciation for eight and one-half months is calculated.[14]

The function of depreciation in separating consumption through use from gain or loss on sale was well summarized by Mr. Justice Brandeis for this Court in the *Ludey* case. The annual depreciation allowance "represents the reduction, during the year, of the capital assets through wear and tear of the plant used." 274 U. S. at 300. He added that "by using up the plant, a gradual sale is made of it. The depreciation charged is the measure of the cost of the part which has been sold. When the plant is disposed of after years of use, the thing then sold is not the whole thing originally acquired. The amount of the depreciation must be deducted from the original cost of the whole in order to determine the cost of that disposed of in the final sale of properties." 274 U. S. at 301.

The purchaser of a ship or other depreciable business property having a salvage value pays, in effect, for two assets: the asset he expects to consume in his business (the "wasting asset") and the asset that will remain when the usefulness of the property to him ends (the "nonwasting

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[11] Paton, *op. cit. supra* 777. The only exception, Paton adds, is where the profit or loss is due, not to market factors, but to "understatement or overstatement of depreciation throughout the elapsed life."

[12] Saliers, *op. cit. supra* 132-133.

[13] Paton, *op. cit. supra* 685.

[14] *Id.* at 773.

asset"). Salvage value is the portion of the total cost allocated to the nonwasting asset. The allocation resembles that made by the purchaser of improved real estate between the building (wasting asset) and the land (nonwasting asset). This allocation of cost is necessary because the cost of the wasting asset is distributed over its useful life and the cost of the nonwasting asset is reserved for determination of gain or loss on its disposition. If the value of the nonwasting asset increases above its cost in a rising market, this does not show that the cost allocation was wrong. If the increased value of the nonwasting asset in the rising market is realized by sale, this does not prove that the writeoff of the cost of the wasting asset has been excessive.

Only by adhering to a cost allocation fairly made on the basis of the conditions existing at the time of purchase can the allowance for consumption of the wasting asset be properly separated from the gain or loss on disposition of the nonwasting asset. The former occurs through use and passage of time; the latter is the result of inflation, scarcity and other market factors. Adherence to that cost allocation produces a fair reflection of income from operations by separating operating revenue and expense from special profit or loss upon sale of plant or equipment.

The Second Circuit has erroneously substituted for this sound principle of depreciation accounting a new theory recently improvised by the Commissioner. Under this new theory, depreciation for the year of sale of property is calculated by substituting the selling price of the property for the portion of the cost assigned to the nonwasting asset. "All that is required" to compute depreciation for the year of sale, says the Second Circuit, "is a comparison of the

asset's selling price with its adjusted basis." (R. 81.) Coining the phrase "net cost" to describe the difference between cost and selling price, the Second Circuit asserts that "the depreciation allowance is measured by the net cost of the asset to the taxpayer." (R. 81.) This novel rule is to be blindly applied even though "the depreciation schedule adopted by the taxpayer" is not "unreasonable" (R. 80) and "the increment in . . . value" realized on sale "resulted from a fortuity normally associated with capital gain." (R. 81.)

The Second Circuit aggravates its error by applying its "net cost" rule to the computation of depreciation for the year of unanticipated sale of property in the middle of its useful life.[15] In such a sale, the purchaser pays for going-concern value or increased profitability from use of the property. The realization of such potential excess of earning capacity has nothing to do with depreciation.[16] The Second Circuit, in computing depreciation for the year of sale by substituting a known quantity (sales price in the middle of useful life) for an estimate (salvage value at the end of useful life), forgot that the known figure was not relevant to the computation under depreciation accounting principles.

The Second Circuit's error is most simply illustrated in terms of the type of depreciable property, such as a patent, that inherently has no salvage value. Assume that a taxpayer purchases for $100,000 a patent that will expire in five years, and that the patent yields him royalties of $30,000 annually. On the straight-line basis the taxpayer writes off $20,000 of the cost of the patent against each year's royalties. His decision at the end of the third year

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[15]See p. 4, *supra*, as to the circumstances of petitioner's sale of the *Feuer*.

[16]Dewing, *op. cit. supra* note 11, at 581 note mmm.

to realize through sale the expected earnings of the patent for the remaining two years[17] should not deprive him of depreciation for the year of sale. The allocation of the cost of the patent 60 percent to the sales price and only 40 percent to the three years of its productivity for the taxpayer is an abuse of depreciation principles for ulterior ends.

The Second Circuit's departure from the theory and practice of depreciation accounting unfairly commingles and distorts two separate taxable events—the income from use of property and the gain on its sale—for which Congress has provided different methods of taxation.

II. Deductibility of Depreciation for the Year of Sale Is Established by Administrative, Judicial and Legislative Precedent and Has Become a Rule of Law by Reenactment of the Statute.

Allowance of depreciation for the year of sale of property—whether or not the sale is at a profit—is established by more than four decades of administrative practice and rulings, by judicial decisions, and by clearly announced Congressional views, and has been elevated to a rule of law by repeated statutory reenactment.

A. Long Standing Administrative and Judicial Precedent Establishes that Depreciation Is Deductible for the Year of Sale.

From the enactment of the modern income tax until very recently, all parties concerned—the Commissioner, taxpayers and the courts (including this Court)—accepted for tax purposes the accounting principle that depreciation

[17] "The value of a patent lies primarily in the probable earnings it will bring its owner." Paul, Federal Estate and Gift Taxation, 1249 (1942).

should be taken in the year of profitable sale of depreciable property. A long series of court decisions reflects the Commissioner's practice of allowing such depreciation and the acceptance of that practice by taxpayers generally and by the courts. Since most of the affected taxpayers, though disputing other adjustments, accepted the principle that depreciation is allowable for the year of the profitable sale, that principle was usually not placed in issue. Nevertheless, this long line of cases clearly shows that the Commissioner, the taxpayers and the courts regularly took for granted that the sale of property at a profit does not prevent deduction of depreciation for the year of sale.

An early example of the allowance of depreciation for the year of profitable sale is *Eldorado Coal & Mining Co.* v. *Mager*, 255 U. S. 522 (1921), where the issue was whether gain on sale of a mining plant is constitutionally taxable as income. Both the taxpayer and the Commissioner computed gain on the sale in that case by subtracting depreciation "to the date of sale." 255 U. S. at 526.[18] This practice was again reflected in *United States* v. *Ludey*, *supra*, in which this Court held that the basis of property had to be reduced by depreciation for the purpose of determining gain on its sale.[19] The Commissioner, in determining the basis of property sold in February 1917, reduced original basis by depletion and depreciation sustained up to "the date of sale in February 1917," and the Court of Claims employed this method of computation in making its findings as to the amount of depreciation sustained. *Ludey* v. *United States*, 61 Ct. Cl. 126 (1925), and Finding V therein. In its brief in the *Ludey* case in this Court, the Government specifically acknowledged that the taxpayer

[18]See also Transcript of Record, *Eldorado Coal & Mining Co.* v. *Mager*, at pp. 3-4.

[19]There was no such specific statutory requirement prior to enactment of the Revenue Act of 1924, discussed at p. 33, *infra*.

was entitled to deduct for 1917, the year of sale, the depreciation actually sustained for that year.[20] Unlike depreciation, the full amount of depletion sustained was not necessarily deductible under the Revenue Act of 1913, and this Court therefore remanded the case so that the reduction of basis could be limited to the amount of deductions found to be allowable. However, this Court did not question the principle that the period for computing depreciation or depletion extended up to the date of sale.

The Commissioner's practice of allowing depreciation to the date of sale was also accepted without question in cases involving various contested issues by the Second Circuit in *Kittredge* v. *Commissioner,* 88 F. 2d 623 (2d Cir. 1937) and *Beckridge Corp.* v. *United States,* 129 F. 2d 318 (2d Cir. 1942); by the Third Circuit in *Clark Thread Co.* v. *Commissioner,* 100 F. 2d 257 (3d Cir. 1938), aff'g 28 B. T. A. 1128, 1140, 1150-51 (1933); by the Eighth Circuit in *Forrester Box Co.* v. *Commissioner,* 123 F. 2d 225 (8th Cir. 1941); by the Court of Claims in *Hall* v. *United States,* 43 F. Supp. 130 (Ct. Cl.), *cert. denied,* 316 U. S. 664 (1942); and repeatedly by the Board of Tax Appeals and the Tax Court. *Grosvenor Atterbury,* 1 B. T. A. 169 (1924); *Even Realty Co.,* 1 B. T. A. 355 (1925); *W. W. Carter Co.,* 1 B. T. A. 849 (1925); *Keighley Mfg. Co.,* 2 B. T. A. 10 (1925); *Marchetti Roma Cafe Co.,* 2 B. T. A. 529 (1925); *Walter Frank,* 2 B. T. A. 905 (1925); *Cotton Concentration Co.,* 4 B. T. A. 121 (1926); *Capital City Investment Co.,* 4 B. T. A. 933 (1926); *Island Line Shipping Co.,* 4 B. T. A. 1055 (1926); *Seton Falls Realty Co.,* 6 B. T. A. 883 (1927); *Parkersburg & Marietta Sand Co.,* 11 B. T. A. 87 (1928); *Louis Kalb,* 15 B. T. A. 865 (1929); *Max Eichenberg,* 16 B. T. A. 1368 (1929); *Franklin Lumber & Power Co.,* 18 B. T. A. 1207 (1930), *rev'd on other*

[20]Brief for the United States, *United States* v. *Ludey,* p. 7.

grounds, 50 F. 2d 1059 (4th Cir. 1931); *Bolta Co.*, T. C. Memo. 5638, 4 CCH T. C. Memo. 1067 (1945).

The deductibility of depreciation for the year of profitable sale was also recognized in a series of early rulings dealing with adjustment of basis for depreciation. In 1922 the Commissioner ruled that depreciation should be computed to the date of disposition of property (I. T. 1158, I-1 C. B. 173); in the same year he described in a ruling the depreciation of an asset to $40,000 in the year of its sale for $47,000 (I. T. 1494, I-2 C. B. 19); in 1924 he again stated that property should be depreciated straight up to the date of its profitable sale (A. R. R. 6930, III-1 C. B. 45); and in 1927 the Commissioner approved a computation of gain on sale of an asset for which depreciation was deducted for the year of sale (G. C. M. 1597, VI-1 C. B. 71).

The Commissioner, having initiated the practice of allowing depreciation for the year of profitable sale under the early Revenue Acts, continued it throughout the succeeding decades, as reflected in recent cases in this Court. In calculating the tax deficiencies of one of the two taxpayers involved in *Massey Motors, Inc.* v. *United States*, 364 U. S. 92 (1960), the Commissioner used a salvage value of $1325 for automobiles sold in the same year for an average of $1380.[21] 364 U. S. at 94-95. Similarly, in the companion case of *Hertz Corporation* v. *United States*, 364 U. S. 122 (1960), the Commissioner accepted returns claiming depreciation under a formula involving deduction of depreciation straight through to the date of profitable sale, and objected only to the taxpayer's attempt to obtain

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[21]No. 143, *Commissioner* v. *Evans*. Since the Commissioner had taken the position in No. 141, *Massey Motors, Inc.* v. *United States*, that the assets were not depreciable because held for sale to customers, that case did not show his depreciation practice.

refunds by changing retroactively to a 200% declining balance method.[22]

Although the general acceptance of the view that depreciation was deductible for the year of profitable sale limited litigation of the issue, the deduction was expressly sustained whenever the issue arose. In *Duncan-Homer Realty Co.,* 6 B. T. A. 730 (1927), the taxpayer, having made a profitable sale during 1923 of real property it had purchased in 1922, deducted depreciation on the property for both years but did not reduce basis by the amount of such depreciation in computing gain on the sale. The gain was taxable as ordinary income because the property had not been held for the two-year period then necessary for capital gain treatment.[23] The Commissioner, while reducing the basis of the property by the amount of the 1922 depreciation for the purpose of determining gain on the sale, disallowed the 1923 depreciation deduction and did not reduce basis for it. In considering the taxpayer's contention that the 1923 depreciation was allowable, the Board of Tax Appeals approved the Commissioner's disallowance only because, the gain on the sale being ordinary income, the resulting tax was the same as if the Commissioner had allowed the 1923 depreciation deduction and reduced basis for it. The Board ruled that the Commissioner's action "was not because of any question as to the right of the petitioner to make the deduction, nor as to the reasonableness of the amount thereof, but rather, it appears, to shorten the computation." 6 B. T. A. at 732.

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[22]See *Hertz Corporation* v. *United States,* 165 F. Supp. 261, 265, 269 (D. Del. 1958), *rev'd,* 268 F. 2d 604 (3d Cir. 1959), *aff'd,* 364 U. S. 122 (1960). The existence of gain on sales of some of the automobiles was clearly shown on exhibits attached to the returns as filed. See pp. 13-18 of the Transcript of Record for that case in this Court.

[23]Rev. Act of 1921, § 206(a)(6), quoted on p. 32, *infra.*

The Board of Tax Appeals later held in *Herbert Simons,* 19 B. T. A. 711 (1930), that a taxpayer had to depreciate property for the year of its profitable sale, even though the depreciation deduction was wasted because his other deductions exceeded his ordinary income for that year. The taxpayer had, during 1924, realized a large capital gain upon sale of an apartment house he had purchased three years earlier. He sought to reduce his capital gain by foregoing depreciation of the apartment house for that year, both as a deduction and as a basis adjustment. The Commissioner contended that the 1924 depreciation deduction "was legal and proper," and the Board upheld this contention as "in accord with the purpose and policy of our revenue statutes, as the same have been interpreted and construed by the courts and this Board." 19 B. T. A. at 712-713.

The issue now before this Court was again squarely resolved by allowance of depreciation for the year of profitable sale in *Wier Long Leaf Lumber Co.,* 9 T. C. 990 (1947), *aff'd and rev'd on other issues,* 173 F. 2d 549 (5th Cir. 1949). A lumber company, having sold some of its business automobiles during 1942, deducted depreciation for that year in amounts that brought the depreciated cost of the automobiles below the price received for them. The parties stipulated in the Tax Court that the depreciation was proper and should be allowed unless it was "controlled by the price received for the automobiles upon the sale thereof." 9 T. C. at 992. The question of law before the Tax Court under this stipulation was "whether the price received from the sale of the depreciated automobiles precludes any depreciation allowance" for the year of sale. 9 T. C. at 999.

Answering this question in the negative, the Tax Court held that depreciation "can not be disallowed merely by

reason of the price received for the article without consideration of other factors." If the profitable price received for the automobiles was due to "a miscalculation as to their useful life" depreciation might be adjusted. But "mere appreciation in value due to extraneous causes has no influence on the depreciation allowance, one way or the other." The "sole fact . . . that a given price is received for articles not fully depreciated throws no light . . . upon the depreciation allowance." 9 T. C. at 999.

The Tax Court did not hold in *Wier* that the Commissioner must accept erroneous estimates of salvage value. Bad estimates are always subject to challenge, even for the year of sale. This is shown by the Tax Court's holding in the same case with respect to the issue of depreciation of a sawmill. The lumber company had depreciated the mill, which it had acquired with an extensive tract of standing timber in 1918, under a formula involving an assumed salvage value of $15,000. On January 1, 1942, the mill had a depreciated cost of less than $25,000, and the company had remaining less than a year's supply of standing timber. In December of 1942, after cutting almost all of the timber, the company sold the mill and certain equipment for $75,000. The company deducted almost $10,000 of depreciation with respect to the mill for 1942, which the Commissioner disallowed. 9 T. C. at 991-992. The company presented no evidence in the Tax Court of the "amount which should properly be attributed to anticipated salvage of the mill." 9 T. C. at 999. Since the company had failed to meet its burden of showing that the mill had not been fully depreciated at the beginning of 1942, the Tax Court sustained the Commissioner's disallowance.

The Tax Court's decision with respect to the mill thus supports and clarifies its decision with respect to the automobiles. The sale of property for more than its depreciated

cost at the beginning of the year of sale does not require disallowance of depreciation for that year as a matter of law. What is reasonable depreciation remains a question of fact to be determined from all known conditions. 9 T. C. at 998.

The Commissioner promptly acquiesced in the *Wier* decision.[24] Since the automobile depreciation issue was the only one decided adversely to the Commissioner by the Tax Court in the *Wier* case, the meaning of the acquiescence is clear. Having been rebuffed in his only attempt, in disregard of the existing rulings and cases, to establish a rule of law denying depreciation of property for the year of its profitable sale, the Commissioner publicly agreed that there was no such rule of law.

The income tax regulations relating to depreciation furnish further proof of the Commissioner's continuing acceptance of the allowability of year-of-sale depreciation. Preparation of the depreciation regulations under the Internal Revenue Code of 1954 received extensive consideration.[25] Those regulations are far more detailed than the depreciation provisions of earlier editions of the income tax regulations.[26] They specify that an asset may not be depreciated below a reasonable salvage value;[27] that salvage value shall not be changed merely because of changes in price levels and shall be redetermined only when useful life is also redetermined;[28] that a proportionate part of one

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[24]1948-1 C. B. 3. See note 75, *infra* p. 40, as to the recent withdrawal of this acquiescence.

[25]The depreciation regulations first proposed under the 1954 Code, which were issued under a notice of proposed rule making on September 28, 1954, were withdrawn in favor of a new set of proposed regulations on November 9, 1955. 20 F. R. 8454. After further revision following public comment and hearings, the regulations were finally approved on June 7, 1956 by T. D. 6182, 1956-1 C. B. 98.

[26]Compare Treas. Reg. §§ 1.167(a)-1 to 1.167(i)-1 with Treas. Reg. 118, §§ 39.23(l)-1 to 39.23(l)-10.

[27]Treas. Reg. § 1.167(a)-1(a).

[28]Treas. Reg. § 1.167(a)-1(c).

year's depreciation is allowable for that part of the last year during which the asset was in service;[29] that when an asset is retired or disposed of, appropriate adjustments shall be made in the asset and depreciation reserve accounts;[30] that when an asset is sold at arm's length, recognition of gain or loss is subject to the provisions of sections 1002, 1231 and other provisions of law;[31] and that upon sale or other retirement of an asset from a multiple asset account the "salvage value estimated in determining the depreciation deduction" shall be used as the "adjusted basis" of the asset "for determining gain or loss upon . . . sale."[32] It is inconceivable that the regulations could have been so written if they had not been intended to conform to the Commissioner's acquiescence in the *Wier* case. It is equally inconceivable that the Commissioner would have decided by 1956 to do an about-face on this issue without clearly so stating in these otherwise detailed regulations.

If further proof were needed, it is found in the Commissioner's republication in the regulations in 1957[33] of a computation, originally introduced into the regulations in 1951,[34] showing depreciation to be deductible for the year of profitable sale. These regulations, interpreting the statutory requirement that gain upon the sale of amortiza-

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[29]Treas. Reg. § 1.167(a)-10(b).

[30]Treas. Reg. § 1.167(a)-1(c).

[31]Treas. Reg. § 1.167(a)-8(a)(1).

[32]Treas. Reg. § 1.167(a)-8(c). The term "retirement" as used in this regulation includes sale, Treas. Reg. § 1.167(a)-8(a).

[33]Treas. Reg. § 1.1238-1, Example (1), adopted by T. D. 6253, 1957-2 C. B. 547, 562, as it read prior to its amendment on June 2, 1965 by T. D. 6825, 1965-26 I. R. B. 6. See text at note 76, *infra* p. 40, as to such recent amendment.

[34]Treas. Reg. 111, §29.117-9(a), added by T. D. 5851, 1951-2 C. B. 63. This regulations provision was based on the Report of the House Committee on Ways and Means discussed at pp. 34-35, *infra*. The provision was also republished in 1953 in Treas. Reg. 118, § 39.117(g)-2(a).

ble emergency facilities be treated as ordinary income to the extent of the excess of amortization over depreciation, provide a computation of gain on sale of the unamortizable portion of the facility. In the example, the unamortizable portion of a facility having a useful life of 20 years was purchased on December 31, 1954, for $10,000; depreciation of $500 a year was deducted for each of the years 1955 and 1956, bringing the depreciated cost to $9,000; and, upon sale of the unamortizable portion of the facility on December 31, 1956, for $9,500, a $500 capital gain was realized. Sale of the property at the end of 1956 for an amount equal to its depreciated cost at the beginning of that year does not bar deduction of a full year's depreciation.

The rule that the actual period of use and sales price do not supplant proper estimates of useful life and salvage value is established not only by the above precedents dealing with a profitable sale, but also by rulings and decisions where the sale was at a loss. Thus, the Commissioner ruled in O. D. 753, 3 C. B. 171 (1920), that the sale of depreciable property at a loss did not terminate its useful life and did not permit an increased depreciation deduction for the year of sale. Similarly, in *Star Sporting Goods Co.*, 1 B. T. A. 1266 (1925), the Commissioner, with the approval of the Board of Tax Appeals, limited depreciation for the year of unprofitable sale to the amount computed under the original estimates of useful life and salvage value, and reduced basis for such depreciation in computing loss on the sale. And in *Thomas Goggan & Bro.*, 45 B. T. A. 218 (1941), the Board squarely held that the amount realized on disposition of property at a loss does not automatically become salvage value.

The taxpayer in the *Goggan* case traded in a business automobile during 1938 at a trade-in allowance about $200 less than depreciated cost. Since deduction of the $200 loss

was prevented by a nonrecognition provision,[35] the taxpayer sought to augment by that amount its depreciation deduction for the year of trade. However, the Board of Tax Appeals, sustaining the Commissioner, limited depreciation to the rate used in prior years. The "allowance of depreciation," said the Board, "depends upon the actual usage of the property." The "trade-in value allowed on an automobile which has been used in a trade or business for a given period can not be said to determine the amount or the rate of the depreciation to be allowed on it in any year of its use." 45 B. T. A. at 225.

The Fifth Circuit espoused the same view in *Whitaker* v. *Commissioner,* 259 F. 2d 379 (5th Cir. 1958), in which the taxpayer had purchased a race horse in August 1948 for $9,000 and, after the horse became injured, sold it in December 1950 for $1,000. The Commissioner allowed depreciation on the horse at the rate of $1,500 a year for the 2⅓ years of ownership, bringing the depreciated cost in December 1950 to $5,500, and treated the difference between such depreciated cost and the $1,000 sale price as a long-term capital loss. The Fifth Circuit, affirming the Tax Court, rejected the taxpayer's argument that the sale of the race horse established its salvage value. The Fifth Circuit, comparing a race horse to a delicate piece of machinery, said that "on a straight line basis, an allowance for accelerated depreciation depends upon showing that the effective life of the machinery was shortened by excessive use, added wear and tear." 259 F. 2d at 385. Realization of a change in value through sale will not sustain a change in depreciation unless it is related to the factor of wear and tear.

In summary, a wealth of precedent accumulated over the decades of the modern income tax establishes beyond

[35]Rev. Act of 1938, § 112(b)(1).

doubt the correctness of the taxpayer's position here. Useful life and salvage value, if fairly established, are not automatically supplanted for depreciation purposes by the actual period of use and the amount realized on sale. For both business accounting and income tax purposes, depreciation in the year of profitable sale is necessary to a fair separation of operating income from gain on sale.

B. Deductibility of Year-of-Sale Depreciation Is Established as a Rule of Law by Legislative History and Reenactment.

Over the same decades in which the abundant judicial and administrative precedent we have discussed was accumulating, Congress repeatedly reenacted the depreciation provision without relevant change. The key words of the present statute—"a reasonable allowance for the exhaustion, wear and tear" of business property—were first enacted in the Revenue Act of 1913.[36] Congress reenacted these words in the Revenue Acts of 1916, 1918, 1921, 1924, 1926, 1928, 1932, 1934, 1936 and 1938 and in the Internal Revenue Codes of 1939 and 1954.[37]

This Court has held many times that Congressional reenactment of a statute without relevant change is deemed to give the force and effect of law to the prior long-continued and uniform judicial or administrative construction of the statute. *Cammarano* v. *United States,* 358 U. S. 498, 510-511 (1959); *United States* v. *Allen-Bradley Co.,* 352 U. S. 306, 310 (1957); *Corn Products Refining Co.* v. *Commissioner,* 350 U. S. 46, 52-53 (1955); *Lykes* v. *United States,* 343 U. S. 118, 127 (1952); *Wilmette Park Dist.* v. *Campbell,* 338 U. S. 411, 417-418 (1949); *Commissioner*

[36] Rev. Act of 1913, §IIB, reproduced in Appendix B, *infra* pp. 1b-3b.

[37] The depreciation provisions of these Acts and Codes are cited and reproduced in Appendix B, *infra* pp. 1b-3b.

v. *Flowers,* 326 U. S. 465, 469 (1946); *Boehm* v. *Commissioner,* 326 U. S. 287, 291-292 (1945); *White* v. *United States,* 305 U. S. 281, 291 (1938); *Helvering* v. *Winmill,* 305 U. S. 79, 83 (1938); *Taft* v. *Commissioner,* 304 U. S. 351, 356-357 (1938); *Hartley* v. *Commissioner,* 295 U. S. 216, 220 (1935); *Old Mission Portland Cement Co.* v. *Helvering,* 293 U. S. 289, 293-294 (1934); *Reinecke* v. *Smith,* 289 U. S. 172, 175 (1933); *United States* v. *Dakota-Montana Oil Co.,* 288 U. S. 459, 466 (1933); *Norwegian Nitrogen Products Co.* v. *United States,* 288 U. S. 294, 313-315 (1933); *Mass. Mutual Life Ins. Co.* v. *United States,* 288 U. S. 269, 273 (1933); *Costanzo* v. *Tillinghast,* 287 U. S. 341, 345 (1932); *Murphy Oil Co.* v. *Burnet,* 287 U. S. 299, 307 (1932); *United States* v. *Ryan,* 284 U. S. 167, 174-175 (1931); *McCaughn* v. *Hershey Chocolate Co.,* 283 U. S. 488, 492-493 (1931); *Brewster* v. *Gage,* 280 U. S. 327, 337 (1930); *National Lead Co.* v. *United States,* 252 U. S. 140, 146-147 (1920); *United States* v. *Cerecedo Hermanos y Compania,* 209 U. S. 337, 339 (1908); *United States* v. *Bailey,* 9 Pet. (U. S.) 238, 253 (1835). In *Helvering* v. *Winmill, supra,* Mr. Justice Black, speaking for the Court, said: "Treasury regulations and interpretations long continued without substantial change, applying to unamended or substantially reenacted statutes, are deemed to have received Congressional approval and have the effect of law." 305 U. S. at 83.

In the above cases this Court invoked the reenactment rule to validate interpretations on which the Government was continuing to rely. However, the rule applies with equal force to prevent Government officials from doing an about-face on long-continued interpretations that have earned Congressional approval through statutory reenactment. *United States* v. *Leslie Salt Co.,* 350 U. S. 383, 396-397 (1956); *McFeely* v. *Commissioner,* 296 U. S. 102,

109-110 (1935); *Zellerbach Paper Co.* v. *Helvering,* 293 U. S. 172, 179-180 (1934); *Helvering* v. *Bliss,* 293 U. S. 144, 151 (1934); *Poe* v. *Seaborn,* 282 U. S. 101, 116 (1930). As Mr. Justice Harlan said for this Court in *United States* v. *Leslie Salt Co., supra,* "Against the Treasury's prior longstanding and consistent administrative interpretation its more recent *ad hoc* contention as to how the statute should be construed cannot stand." 350 U. S. at 396.

This is not a case in which no reliable inference can be drawn from reenactment because of a lack of long and well settled interpretation or the presence of a conflict in administrative and judicial interpretation at the time of reenactment. Cf. *Commissioner* v. *Acker,* 361 U. S. 87, 93 (1959); *United States* v. *Calamaro,* 354 U. S. 351, 358-359 (1957); *Commissioner* v. *Glenshaw Glass Co.,* 348 U. S. 426, 431-432 (1955); *Jones* v. *Liberty Glass Co.,* 332 U. S. 524, 533-534 (1947); *White* v. *Winchester Country Club,* 315 U. S. 32, 39-40 (1942); *Helvering* v. *Reynolds,* 313 U. S. 428, 430, 433 (1941); *Higgins* v. *Smith,* 308 U. S. 473, 479 (1940); *Helvering* v. *Wilshire Oil Co.,* 308 U. S. 90, 99-100 (1939); *Helvering* v. *New York Trust Co.,* 292 U. S. 455, 467-468 (1934); *Iselin* v. *United States,* 270 U. S. 245, 251 (1926). Instead, the pattern here is of unambiguous administrative conduct "adopted by the Commissioner in the early days of federal income tax legislation, in continuous existence since that time, and consistently construed and applied by the courts on many occasions." *Cammarano* v. *United States, supra,* at 511.

Moreover, this is not a case in which the reenactment rule is inapplicable because the long-settled interpretation plainly misinterpreted an unambiguous statute. Cf. *Jones* v. *Liberty Glass Co., supra; Biddle* v. *Commissioner,* 302 U. S. 573, 582 (1938); *Louisville & Nashville R. R.* v. *United States,* 282 U. S. 740, 757-758 (1931); *Iselin* v.

United States, supra. The statute is not "so plain in its commands as to leave nothing for construction." *Norwegian Nitrogen Products Co.* v. *United States, supra,* at 315. Administrative construction followed by reenactment is given particular weight where the statute is sufficiently general or doubtful as to give broad interpretive discretion. *United States* v. *Allen-Bradley Co., supra,* at 308-309; *McCaughn* v. *Hershey Chocolate Co., supra,* at 492.

This Court has presumed without express proof that Congress in reenacting a statute is familiar with interpretations of it which are published and long-standing.[38] It is not necessary, however, to indulge in such a presumption here, for, as we show below, this case involves the "close supervision" of the statute by Congress that this Court found meaningful in *United States* v. *Allen-Bradley Co., supra,* at 310.

In 1921 Congress first enacted favorable tax treatment for capital gain. Such treatment was granted to sales of property, including depreciable property, "acquired and held by the taxpayer . . . for more than two years (whether or not connected with his trade or business)."[39] This Court has held that this first enactment of a reduced rate for capital gain should not be held to circumscribe deductions "granted in the earlier Acts, and retained in later ones, . . . unless that result be plainly required by the language used."[40] It is clear that Congress did not intend to circumscribe the depreciation deduction, for it reenacted it without

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[38]See cases cited at pp. 29-30, *supra.* This presumption is not applied to interpretations of short duration, *United States* v. *Calamaro, supra; Helvering* v. *New York Trust Co., supra,* or to an "administrative practice not reflected in any published ruling or regulation." *Commissioner* v. *P. G. Lake, Inc.,* 356 U. S. 260, 266 note 5 (1958).

[39]Rev. Act of 1921, § 206(a)(6).

[40]*Helvering* v. *Bliss, supra* p. 31, at 151.

change.[41] And it did so with obvious familiarity with current interpretations, for the accompanying committee report cited the two companion decisions of this Court to *Eldorado Coal & Mining Co.* v. *Mager, supra.*[42]

In 1924 Congress legislated against the taxpayer practice of not reducing the basis of depreciable property by depreciation for the purpose of determining gain or loss upon sale.[43] The accompanying committee report announced that this legislative provision "is substantially the same as the construction placed upon the existing law by the Treasury Department."[44] Since the construction to which Congress thus referred was set forth in the rulings and cases we have described allowing depreciation for the year of profitable sale, Congress demonstrably had knowledge that depreciation was deductible for that year.

In 1938 Congress excluded depreciable business property from the definition of a capital asset.[45] However, Congress took this action, not out of concern that taxpayers were realizing capital gain on sales of depreciable property, but so that loss on sales of such property would be fully deductible from ordinary income instead of subject to capital loss limitations.[46] The report of the Committee on Ways and Means on this provision made it clear that, but for the change, loss on sale of a depreciable asset could not be charged against ordinary income.[47] This report thus exhibited Congressional knowledge of the principle

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[41]Rev. Act of 1921, §§ 214(a)(8) and 234(a)(7), reproduced in Appendix B, *infra* pp. 1b-3b.

[42]S. Rep. No. 275, 67th Cong., 1st Sess. 15 (1921), citing *Goodrich* v. *Edwards*, 255 U. S. 527 (1921), and *Walsh* v. *Brewster*, 255 U. S. 536 (1921).

[43]Rev. Act of 1924, § 202(b). See pp. 19-21, *supra*.

[44]H. Rep. No. 179, 68th Cong., 1st Sess. 12 (1924).

[45]Rev. Act of 1938, § 117(a)(1).

[46]H. Rep. No. 1860, 75th Cong., 3d Sess. 6 (1938).

[47]*Id.* at 34-35.

of O. D. 753 and the *Star Sporting Goods* case, *supra* p. 27, that sales price does not supplant salvage value.

In 1942 Congress restored capital gain treatment to depreciable business property.[48] The accompanying committee report stated that "it appears that many taxpayers are able to dispose of their depreciable property at a gain over its depreciated cost. To treat such a gain as an ordinary gain will result in an undue hardship to the taxpayer."[49] At the same time, Congress left the depreciation provision unchanged except for expanding its scope to cover nonbusiness property held for the production of income.[50]

Thereafter and up to the time of the most recent reenactment of the depreciation provision in 1954, Congress was again concerned with the relationship between depreciation and capital gain on the following occasions:

(1) In 1947 Congress received from the Treasury Department, but did not adopt, a legislative recommendation that gains on sales of assets subject to accelerated depreciation should, to the extent of the excess of accelerated over normal depreciation, be treated as ordinary income.[51]

(2) In developing the Revenue Act of 1950, Congress considered but rejected a proposal that all gains from sales of depreciable property be taxed as ordinary income.[52] At

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[48]Int. Rev. Code of 1939, § 117(j), added by Rev. Act of 1942, § 151(b).

[49]H. Rep. No. 2333, 77th Cong., 2d Sess. 54 (1942).

[50]Rev. Act of 1942, § 121(c).

[51]Hearings before the Committee on Ways and Means, House of Representatives, 80th Cong., 1st Sess. on Revenue Revisions 1947-48, Part 5, page 3756 (Report of Business Tax Section, Division of Tax Research, Treasury Department). See note 63, *infra* p. 38.

[52]The 1950 Act as passed by the House of Representatives followed the recommendation of the Treasury Department that losses on sales of depreciable assets be treated as capital rather than ordinary losses. H. Rep. No. 2319, 81st Cong., 2d Sess. 45 (1950). The Senate rejected this change (S. Rep. No. 2375, 81st Cong., 2d

the same time, Congress enacted a provision requiring gain upon sale of amortizable emergency facilities to be treated as ordinary income to the extent of the excess of amortization over depreciation.[53] The conference report on this provision expressly recognized that depreciation was deductible up to the date of profitable sale of depreciable property. The report gave an example of the sale for $9,500 of an emergency facility having a basis after amortization of $6,000. Depreciation (including $500 for the year of sale) would have brought its basis down only to $9,000. The report stated that $3,000 of the gain on sale would be treated as ordinary income and $500 as capital gain.[54] The clearly expressed Congressional view was that realization of capital gain upon the sale of the depreciable asset does not bar depreciation for the year of sale.

(3) In 1951 the Internal Revenue Service called the attention of Congress to sales of depreciated assets between related taxpayers for the purpose of obtaining a combination of capital gain on the sale and an increased basis for future depreciation.[55] Congress legislated against this device by requiring gain on sales between an individual and his controlled corporation or between certain closely related individuals to be treated as ordinary income,[56] but left

Sess. 51-52 (1950)) and its approach prevailed. In the Senate floor discussion, Senator Millikin (the ranking minority member of the Committee on Finance) stated that "the reverse procedure which involves conforming the treatment of gains to losses and taxing the gains on the sale of section 117(j) assets as ordinary income also present serious difficulties" and, hence, the "Committee decided that it was best not to change section 117(j) at this time." 96 Cong. Rec. 14057 (1950).

[53] Rev. Act of 1950, § 216(c).

[54] H. Rep. No. 3124, 81st Cong., 2d Sess. 29 (1950). This Report was the basis of the similar example in the Treasury Regulations referred to at pp. 26-27, *supra*.

[55] H. Rep. No. 586, 82d Cong., 1st Sess. 26 (1951).

[56] Int. Rev. Code of 1939, § 117(o), added by Rev. Act of 1951, § 328(a).

capital gain treatment otherwise available for sales of depreciable assets.

(4) During the development of the Internal Revenue Code of 1954, Congress again received, but did not adopt, a recommendation that gains from sales of depreciable assets should be taxed as ordinary income.[57] Congress reenacted capital gain treatment for depreciable assets in 1954[58] even though it realized that the new rapid depreciation methods it was authorizing would accentuate the advantage of capital gain treatment.[59] The report of the Committee on Finance on the new depreciation provisions showed Congressional awareness that estimated salvage value may not be adjusted downward to coincide with the price received on sale of depreciable property at a loss.[60]

Congressional understanding of the interrelation between depreciation and gain on sale, and its knowledge that depreciation is allowable for the year of sale, is manifest in the above legislative history. This history of informed Congressional reenactment and legislative revision calls for application of the doctrine that the reenacted statute embodies the long and uniform interpretation. That doctrine

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[57]Hearings before the Committee on Finance, United States Senate, 83d Cong., 2d Sess. on H. R. 8300, Part 3, p. 1324 (Recommendation No. 180 of American Inst. of Accountants).

[58]Int. Rev. Code of 1954, § 1231. "This section is derived from section 117(j) of present law. There is no substantive change intended. . . ." H. Rep. No. 1337, 83d Cong., 2d Sess. A275 (1954).

[59]Int. Rev. Code of 1954, § 167(b)(2), (3) and (4). In the floor discussion, Representative Curtis (a member of the Committee on Ways and Means) called the attention of the House to the fact that the combination of the new depreciation methods and the capital gain provisions of § 1231 might well "accentuate" already existing tax advantages. 100 Cong. Rec. 3678 (1954).

[60]S. Rep. No. 1622, 83d Cong., 2d Sess. 27 (1954). This point was also made in the hearings by Undersecretary of the Treasury Folsom. Hearings before the Committee on Finance, United States Senate, 83d Cong., 2d Sess. on H. R. 8300 (Internal Revenue Code of 1954), Part 1, p. 118.

is especially relevant where, as here, the interpretation was not a recondite one known only to tax specialists, but a practical matter familiar to businessmen, lawyers and accountants generally. Since the Congressional membership is largely drawn from and is in constant contact with these groups, it is not surprising that its legislative actions and reports reflect thorough familiarity with the long established interpretation.

Against the above background, the Treasury's shift in position is simply an effort to collect as much tax as possible, without regard to whether the tax has been "authorized by Congress." *Helvering* v. *Griffiths,* 318 U. S. 371, 394 (1943). If the Treasury regards as unsound tax policy the disparity in tax treatment of depreciation deductions and profit on sale of depreciable property, the remedy is to repair to Congress for new legislation. "[S]uch a determination of policy in the administration of the income tax law should be made by Congress, which maintains a Joint Committee of Internal Revenue Taxation charged with the duty of investigating the operation of the federal revenue laws and recommending such legislation as may be deemed desirable." *United States* v. *Nunnally Investment Co.,* 316 U. S. 258, 264 (1942). If the Treasury has decided since 1960[61] that allowance of depreciation for the year of profitable sale is unsound tax policy, it could have asked for statutory disallowance in any of its messages to Congress on the subject of depreciation and capital gain.[62]

The Treasury has become increasingly concerned in recent years over the continued eligibility for capital gain treatment of property subject to new methods of accelerated

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[61]See pp. 21-22, *supra* and 40-41, 47-48, *infra.*

[62]See notes 64, 65 and 67, *infra.*

depreciation.[63] In 1960[64] and again in 1961[65] the Treasury asked Congress to deal with this problem by treating gain on disposition of property as ordinary income to the extent of depreciation taken on the property. Congress partially responded in 1962 by providing that gain on future dispositions of personal property should be so treated to the extent of depreciation taken for years after 1961.[66] In 1963 the Treasury renewed its request that similar treatment be given to real property.[67] Congress again made a limited response by providing for partial recapture of post-1963 depreciation as ordinary income upon future dispositions of real property.[68]

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[63]The Treasury had authorized declining balance depreciation in 1946 (I. T. 3818, 1946-2 C. B. 42); Congress had enacted more rapid depreciation methods in 1954 (Int. Rev. Code of 1954, § 167 (b)(2), (3) and (4)); and the Treasury introduced greatly liberalized depreciation guidelines in 1962 (Rev. Proc. 62-21, 1962-2 C. B. 418). See note 51, *supra* p. 34, for the Treasury's 1947 legislative recommendation for recapture of accelerated depreciation as ordinary income. See also note 59, *supra,* p. 36.

[64]The Budget of the United States Government for the Fiscal Year ending June 30, 1961, at M11; Treasury Department Release A-761, dated February 15, 1960.

[65]Message from the President reprinted in Hearings before the Committee on Ways and Means, House of Representatives, on the President's 1961 Tax Recommendations (H. Doc. No. 140, 87th Cong., 1st Sess.), vol. 1 at 13. The testimony of the Secretary of the Treasury on this recommendation is recorded at pp. 45-46 of those Hearings.

[66]Int. Rev. Code of 1954, § 1245, added by Rev. Act of 1962, § 13(a).

[67]Hearings before the Committee on Ways and Means, House of Representatives, on the President's 1963 Tax Message (H. Doc. No. 43, 88th Cong., 1st Sess.), vol. 1 at 57 (Statement of Secretary of the Treasury).

[68]Int. Rev. Code of 1954, § 1250, added by Rev. Act of 1964, § 231(a). Such recapture was complete for real property held for one year or less; was limited to a sliding-scale fraction of the excess of accelerated over straight-line depreciation for real property held for more than one but less than ten years; and was not provided at all for real property held for ten years or more.

Legislative action in this important area of tax policy is preferable to piecemeal litigation. "Congress can deal with the matter comprehensively, unembarrassed by the limitations of a litigation involving only one phase of a complex problem." *United States* v. *Nunnally Investment Co., supra.* Judicial acceptance of the innovation urged here by the Commissioner would inevitably upset established loss limitations. If useful life and salvage value were redefined to mean the actual period the property is held and the amount realized on its disposition, many capital losses and nonrecognized losses for which Congress has limited or denied deduction would be converted into deductible depreciation. The losses so affected would include loss on sale of nonbusiness depreciable property held for the production of income, now treated as capital loss;[69] losses on sale of business property covered by section 1231 of the Internal Revenue Code that are treated as capital losses because they are exceeded by gains;[70] and losses nonrecognized under various provisions of the Internal Revenue Code.[71] The revenue impairment from this conversion of nondeductible losses into deductible depreciation would, of course, continue in the years for which Congress has already provided for recapture of depreciation as ordinary income on sale at a gain by enacting sections 1245 and 1250 of the Internal Revenue Code.

The Commissioner has attempted to limit his overthrow of precedent to the situation in which a gain is realized on

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[69]*E.g.,* the race horse in *Whitaker* v. *Commissioner, supra* p. 28.

[70]*E.g.,* a $30,000 loss on sale of a building realized in the same year as a $40,000 gain on sale of a parking lot.

[71]*E.g.,* losses realized during corporate liquidation under section 337 of the Internal Revenue Code, as in the present case, and losses accrued on depreciable property distributed in complete liquidation and then sold, as in *Kimball Gas Products Co.* v. *United States,* note 102, *infra* p. 48.

sale of the depreciable property,[72] but this limitation is untenable under the principle he is urging. If actual sales price is salvage value, this is true whether the sale is profitable or unprofitable. The Commissioner cannot shift from one view to another in the light of "whichever favors the Government" on a particular occasion. *Rosenman* v. *United States,* 323 U. S. 658, 663 (1945).

In both of its recent enactments Congress could validly have provided for recoupment of depreciation taken for periods prior to the year of enactment, but it considered it unwise to disturb existing depreciation patterns so deeply.[73] The Commissioner is asking this Court to do what Congress was unwilling to do. He asks this Court to validate a 1962 change of position[74] that—since Congress has legislated for the future—is almost wholly retroactive. He asks this Court to join him in a rewriting of history in which he has retroactively (1) revoked a 14-year acquiescence in a Tax Court decision allowing the deduction he challenges;[75] (2) reversed a statement of deductibility in a Treasury regulation of 14 years' standing;[76] (3) closed his eyes to the Congressional committee report on which that regulation was based;[77] (4) issued a revenue ruling at odds with 40 years' administrative practice;[78] (5)

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[72]Rev. Rul. 62-92, *infra* at note 99, p. 48.

[73]The statement in the committee reports on the Revenue Act of 1964 to the effect that enactment of section 1250 was not intended to affect the question presented here was nothing more than the traditional Congressional statement of neutrality with respect to current litigation. H. Rep. No. 749, 88th Cong., 1st Sess. 103 (1963); S. Rep. No. 830, 88th Cong., 2d Sess. 133 (1964).

[74]See pp. 47-48, *infra.*

[75]*Wier Long Leaf Lumber Co., supra, acq.* 1948-1 C. B. 3 (withdrawn), *nonacq.* 1962-1 C. B. 5.

[76]T. D. 6825, note 33, *supra* p. 26, amending Treas. Reg. § 1.1238-1.

[77]See pp. 34-35, *supra.*

[78]Rev. Rul. 62-92, *infra* at note 99, p. 48. See pp. 18-29, *supra.*

ignored a large body of consistent judicial authority;[79] and (6) disregarded well articulated Congressional policy.[80]

This attempt at retroactive administrative legislation in defiance of the well settled rule should be rejected.

III. Abandonment of the Principle that Depreciation Is Allowable for the Year of Sale Is Not Warranted by *Cohn* v. *United States*.

For the convenience of the Court we shall now trace the drastic departure of the Commissioner and the Second Circuit from a rule adopted, reaffirmed, accepted and relied on for more than 40 years. We begin with *Cohn* v. *United States,* 259 F. 2d 371 (6th Cir. 1958), on which both the Commissioner[81] and the Second Circuit (R. 78-79) rely to justify their surprising improvisation.

The taxpayers in *Cohn* equipped and operated three flight-training schools during World War II under contracts with the Army Air Corps terminable by it on 30 days' notice. 259 F. 2d at 373. Two of the schools were opened in 1941 and the third in 1942. Late in 1942 the taxpayers, after learning from discussions with Air Corps personnel that the schools would probably not be used beyond 1944, estimated that the useful economic life of their $360,000 of movable equipment would end on December 31, 1944. For the years 1942, 1943 and 1944 they computed depreciation on the basis of such estimated useful life and a zero salvage value.[82] Late in 1944 the contracts were in fact terminated, the schools were closed, and the equipment was sold at auction. Because of wartime shortages and price

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[79]See pp. 18-29, *supra*.

[80]See pp. 29, 32-36, *supra*.

[81]Rev. Rul. 62-92, *infra* note 99, p. 48. See also R. 11.

[82]For simplicity we shall discuss the *Cohn* case in terms of the calendar years 1942, 1943 and 1944. That case actually involved fiscal years of three partnerships ending with different months of the years 1942-1945.

increases the equipment brought about $140,000 more than its cost as depreciated by the taxpayers.

The Commissioner disallowed about $170,000 of the 1942, 1943 and 1944 depreciation deductions by assigning useful lives of 5 years and 10 years to different classes of equipment, and the taxpayers sued in the district court for refund of the resulting additional taxes. 259 F. 2d at 374-375. The district court, while upholding the taxpayers' estimate of useful life, held that salvage value had to be taken into consideration. The district court found salvage value to be an amount equal to 10 percent of cost (about $36,000) for the purpose of determining 1942 and 1943 depreciation, but increased it to an amount equal to the sales price received on auction (about $185,000) for the purpose of determining 1944 depreciation.

The taxpayers appealed to the Sixth Circuit from the finding of the district court as to salvage value for 1944 only. The taxpayers contended that the district court, having fixed salvage value in determining 1942 and 1943 depreciation, had committed an error of law in adjusting such salvage value upward in determining 1944 depreciation.[83] The Government replied that salvage value that was obviously in error could be corrected for any taxable year in the light of conditions then known to exist.[84] The Sixth Circuit took up first this question of law and decided it for the Government. Under the circumstances of the case, the taxpayers having put in issue in the district court the depreciation deductions claimed by them and disallowed by the Commissioner, "the District Judge was not in error as a matter of law in considering both useful life and salvage value." 259 F. 2d at 379.

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[83]Appellants' Brief, p. 22, in *Cohn* v. *United States.*
[84]Appellee's Brief, p. 20, in *Cohn* v. *United States.*

Having decided this question of law, the Sixth Circuit faced the factual question of whether the district court had correctly determined the amount of the contested salvage value. The taxpayers argued that the district court had increased salvage value merely because of the appreciation in value reflected in the sales price, and that such increase was erroneous and in conflict with the decisions in *Thomas Goggan & Bro., supra* p. 27, and *Wier Long Leaf Lumber Co., supra* pp. 23-25.[85] The Government argued in reply: The "question of the proper amount of estimable salvage value" is "clearly one of fact."[86] The district court did not change salvage value "*solely* because of changes in price levels."[87] "[T]here were other circumstances which indicated that a reasonably estimable salvage value existed far in excess of . . . ten percent of cost."[88] "The issue is not . . . whether mere appreciation in value, due to extraneous causes (i.e., wartime shortages and buying restrictions), justifies the adjustment of salvage values in the year the property is sold."[89] The Government admitted that the Board of Tax Appeals had held in the *Goggan* case that the difference between depreciated cost and amount realized "would not, *by itself* and without evidence of actual usage, be sufficient evidence" to warrant revision of salvage value; but, the Government reiterated, "the court below did not base [its] determination on the sale price alone."[90] Turning to the *Wier* case, the Government admitted that the Tax Court had held that the profitable price received upon the sale of the automobiles did not "by itself" preclude depreciation for the year of sale. "Once again," the Government added,

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[85]Appellants' Brief, pp. 12, 15-17, in *Cohn* v. *United States.*
[86]Appellee's Brief, p. 14, in *Cohn* v. *United States.*
[87]*Id.,* p. 27. Emphasis in original.
[88]*Ibid.*
[89]*Id.,* p. 28.
[90]*Id.,* p. 29. Emphasis in original.

"the sales price of the movable assets was not the sole basis of the District Court's finding in this case."[91] The Government then cited a number of cases in which, it contended, "there were, as here, factors in addition to the actual sales price of the assets upon which the reasonableness of the estimates was based."[92]

Again and again the Government on brief in the Sixth Circuit urged that the district court had made nothing more than a narrow finding on all the facts of the case that was not clearly erroneous.[93] For example, the Government responded as follows to the taxpayers' contention that the equation of salvage value to sales price would obviate the Congressional purpose in granting capital gain treatment to sales of depreciable property:

> "We submit that the District Court did no more than find that the reasonably estimable salvage value was, on the facts of this case, equal to the amounts actually received on the sale of the assets involved. The finding was solely predicated on the facts of this case and, on a different set of facts, it is, of course, possible that an entirely different finding would result. The District Court did not bind itself to find in all cases that reasonably estimable salvage value must be equal to the actual salvage value and the Government does not so contend. The conclusions of the court in this respect . . . must be read

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[91] *Id.*, pp. 29-30.

[92] *Id.*, p. 31. The other factors in the *Cohn* case, said the Government, included the "shortages at the time of the purchase of the goods; the prospect that the shortages would increase as the war continued; the non-specialized nature of the assets"; the taxpayers' realization that they would dispose of the equipment long before the expiration of its intrinsic useful life; and the sales prices other schools were obtaining on auctions of similar equipment. *Id.*, pp. 15-17, 27, 34.

[93] *Id.*, pp. 11, 14, 18, 20, 21, 28, 32, 34.

> in conjunction with the basic finding of the court . . . that, in this case, the reasonably estimable salvage value was equal to the actual value. This fact was merely corroborated by the experience shown in the actual sales."[94]

The Sixth Circuit clearly showed in its opinion that it regarded the amount of salvage value as a factual determination, involving no question of law. Accepting the Government's argument that it was being asked to do nothing more than sustain a finding of fact as not clearly erroneous, the Sixth Circuit concluded that the district court's "findings of fact with respect to salvage value . . . are not clearly erroneous and must be sustained." 259 F. 2d at 379.

Three conclusions are immediately clear. First, the Sixth Circuit was not asked to hold—and did not hold—that the sale of depreciable property at a profit bars depreciation for the year of sale as a matter of law. The Commissioner is attempting here to convert the Sixth Circuit's narrow factual holding into a novel and erroneous legal principle the existence of which the Government denied again and again in its Sixth Circuit brief.

Secondly, the district court's equation of salvage value with the amount realized upon sale of the equipment "at or near the end of [its] useful life" (259 F. 2d at 378) does not establish a broad rule that every sale of property—no matter when and under what circumstances made—yields a sales price equal to salvage value. The Tax Court and the Eighth Circuit, realizing the importance of this distinction, have recently disapproved the Commissioner's treatment of sales price realized in the middle of useful life as salvage value. See the discussion of *Macabe Co., infra* page 50, and *United States* v. *S & A Co., infra* page 52.

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[94] *Id.*, p. 32.

Thirdly, to the extent that the *Cohn* case may be read as the Commissioner and the Second Circuit have read it, it is wrong. The error lies in the district court's assignment of a $36,000 salvage value to the equipment for the purpose of computing 1942 and 1943 depreciation and a $185,000 salvage value for 1944 depreciation. If, as the Government argued to the Sixth Circuit, the salvage value of about 50 percent of cost was foreseeable from the outset because of the limited period of usefulness of the property to the taxpayers and the prospect that they would dispose of it while it was in good condition and during a period of wartime shortages—then the higher salvage value should have been used from the beginning. However, if the 10 percent salvage value was reasonable at the outset, then it should not have been adjusted upward. Such upward adjustment of fairly established salvage value to reflect a later unanticipated increase in price levels—whether or not realized by sale—violates every precedent.[95]

This error on the part of the district court should not be lightly attributed to the Sixth Circuit. The Sixth Circuit had only partial jurisdiction of the matter, because neither party had asked it to review the correctness of the district court's determination of salvage value for 1942 and 1943. Since the Sixth Circuit gave no explanation of its one-sentence affirmance of the district court's finding of fact with respect to salvage value for 1944, various inferences are possible. That the Sixth Circuit intended *sub silentio* to disagree with the *Wier* and *Goggan* decisions, which were adequately briefed by the taxpayers and conceded by the Government to be correct statements of law,[96] is the most farfetched of these inferences. Although the Sixth Circuit discussed the difference between annual adjustments to sal-

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[95]See Parts I and II of our argument, pp. 12-41, *supra*.
[96]See pp. 43-45, *supra*.

vage value and a final adjustment in the year of sale, it did so for the very limited purpose of dealing with the taxpayers' argument that annual adjustments would be administratively costly and undesirable. 259 F. 2d at 378. Had the Sixth Circuit intended to initiate a legal principle at odds with more than four decades of administrative, judicial and legislative history, it would have plainly said so.

Not even the Commissioner saw a new legal approach in the *Cohn* decision for several years after it was rendered. The Commissioner allowed depreciation in the year of profitable sale to the taxpayers involved in the *Massey* and *Hertz* cases, *supra* p. 21, decided by this Court in 1960, two years after *Cohn*. In those cases, which held that estimates of useful life and salvage value must reflect the taxpayer's established policy of disposition, this Court recited without disapproving comment the fact of the Commissioner's allowances, while aware of the *Cohn* decision. 364 U. S. 94-95, 117-118.

Such allowances were not through oversight, for the Commissioner stated on brief in this Court his view that such depreciation was allowable: "If salvage value should exceed reasonable expectation—if, for example, the value of used cars should suddenly increase as a result of wartime conditions—realization of capital gain would not show that the method of computing depreciation was impermissible."[97] He added that, consequently, he did not "contend for a hindsight determination of the actual period of usefulness to the taxpayer or of salvage value."[98] Understandably, Mr. Justice Harlan stated in his opinion dissenting in *Massey* and concurring in *Hertz* that "even the Commissioner does not contend that a taxpayer who *hap-*

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[97] Petitioner's Brief, p. 17, in *Commissioner* v. *Evans, supra* note 21, p. 21.

[98] *Id.*, p. 19.

pens to dispose of some asset before its physical exhaustion must depreciate it on a useful life equal to the time it was actually held." 364 U. S. at 113 (emphasis in original).

The Commissioner, like everyone else, still held at the time of the *Massey* and *Hertz* decisions to the established view that depreciation is allowable in the year of profitable sale. His decision to attempt to rewrite history was made later, and was not announced until June of 1962.[99] He relied in his announcement exclusively on the *Cohn, Massey* and *Hertz* decisions for his newly improvised legal doctrine, even though those decisions had all been made in reliance on his statements in his briefs that there was no such doctrine. The support the Commissioner looks for in those decisions is obviously not there.

IV. Recent Cases Continue to Allow Depreciation for the Year of Profitable Sale.

The Commissioner's repudiation of both logic and history has been disapproved by eight of the ten courts that have considered it. The Eighth Circuit,[100] the Tax Court[101] and six district courts[102] have all found it erroneous. Only a

[99]T. I. R. 374, dated June 7, 1962 (the day before the trial of this case in the Tax Court (R. 26)), later republished as Rev. Rul. 62-92, 1962-1 C. B. 29.

[100]*United States* v. *S & A Co.*, 338 F. 2d 629 (8th Cir. 1964), cert. applied for.

[101]*Macabe Co.*, 42 T. C. 1105 (1964), on appeal to Ninth Circuit, and cases cited in notes 106-110, *infra*.

[102]*Wyoming Builders, Inc.* v. *United States*, 227 F. Supp. 534 (D. Wyo. 1964), on appeal to Tenth Circuit; *Occidental Loan Co.* v. *United States*, 235 F. Supp. 519 (S. D. Calif. 1964), on appeal to Ninth Circuit; *Mountain States Mixed Feed Co.* v. *United States*, 65-2 USTC ¶ 9551 (D. Colo. 1965); *Motorlease Corp.* v. *United States*, 215 F. Supp. 356 (D. Conn. 1963), *rev'd*, 334 F. 2d 617 (2d Cir. 1964), cert. applied for; *Kimball Gas Products Co.* v. *United States*, 63-2 USTC ¶ 9507 (W. D. Tex. 1962), on appeal to Fifth Circuit; *S & A Co.* v. *United States*, 218 F. Supp. 677 (D. Minn. 1963), *aff'd*, 338 F. 2d 629 (8th Cir. 1964), cert. applied for.

divided Second Circuit[103] and one district court[104] have held for the Commissioner—and these decisions were made during the period of, and were perhaps influenced by, the Tax Court's temporary allegiance to the Commissioner's novel doctrine.

The Tax Court, after initially embracing the Commissioner's new position in a case where the issue was not sufficiently important to be briefed by the taxpayer,[105] uncritically followed that decision in the present case. (R. 2-18.) Thereafter, the Tax Court, on more thorough consideration, squarely rejected the Commissioner's view in a decision reviewed by the entire court, ***Macabe Co., supra*** note 101. In *Macabe* the taxpayer sold an office building near the end of the ninth year of its estimated 33⅓ year useful life for an amount exceeding the building's adjusted basis at the beginning of the year of sale. 42 T. C. at 1106-1108. The taxpayer had computed its annual depreciation allowance for the building under the straight-line method and a zero salvage value, which the Tax Court found to be reasonable. *Ibid.* The Commissioner disallowed such depreciation for the year of sale solely by using the sales price as salvage value.

The Tax Court rejected the Commissioner's equation of sales price with salvage value "because it fails to take

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[103] Judge Moore dissented from the decision below. Judge Waterman dissented from the decision of another panel of the Second Circuit in *United States* v. *Motorlease Corp.*, 334 F. 2d 617 (2d Cir. 1964), cert. applied for.

[104] *Killebrew* v. *United States*, 64-2 USTC ¶ 9728 (E. D. Tenn. 1964).

[105] *Randolph D. Rouse*, 39 T. C. 70 (1962). The principal issue in the *Rouse* case was whether rental houses were depreciable, and the secondary issue was the proper method of computing depreciation for all years. The taxpayer did not regard the question of year-of-sale depreciation as a separate issue worthy of mention; did not object to the Commissioner's erroneous one-sentence summary of the *Cohn* case; and did not even cite the *Wier* case or any of the other applicable precedents.

into account the distinction between (1) the concept of 'depreciation' or the gradual exhaustion of property and (2) the concepts of 'appreciation' or 'depreciation' in the value of property because of market conditions such as scarcity, inflation, or the like." 42 T. C. at 1109. The "granting of a reasonable allowance for depreciation is a matter separate and distinct from the computation of gain upon the sale of property." *Ibid.* "Depreciation, as that term is used in section 167, occurs through use and the passage of time; such depreciation occurs regardless of market conditions which might otherwise enhance or diminish the value of an asset." *Ibid.* The Tax Court recognized the obvious fact that "the building continued to depreciate in petitioner's hands right up to the time of the sale." *Ibid.*

In disapproving the Commissioner's attempt to equate sales price with salvage value, the Tax Court stated that actual sales proceeds might be evidence of salvage value where property "is sold at or near the end of . . . its useful life to the taxpayer." *Id.* at 1115. Even then, sales price controls only if "the taxpayer fails to establish that all or some specific portion of the sales proceeds resulted from market appreciation, rather than excessive depreciation." *Ibid.* In the case of an unexpected sale in the middle of useful life, however, actual sales price has "little relevance to the amount the property would bring at the end of its useful life." *Ibid.* The "actual sales price would be relevant to salvage value" only "if useful life could be equated with the period for which the taxpayer actually held the property at the time of its sale." *Id.* at 1116. However, "the concept of 'useful life,' is entirely different from that of 'the actual holding period'." *Ibid.*

On the basis of the principles announced in *Macabe*, the Tax Court has since allowed depreciation up to the date

of profitable sale in the case of construction equipment sold as part of a business,[106] rental automobiles,[107] and a shopping center, an Air Force housing project and rental real estate.[108] The Tax Court has denied depreciation in the year of sale only where the taxpayer failed to prove that its estimates of useful life and salvage value were reasonable,[109] or where no revision of a first year's estimate was involved because the taxpayer arranged to sell the property in the year of acquisition.[110]

The Eighth Circuit likewise disapproved the Commissioner's new position in *United States* v. *S & A Co., supra* note 100, in which the taxpayer, a manufacturer of outboard motors, had made a profitable sale of its entire business. Prior to the sale, the taxpayer had intended to use the depreciable property of the business for its entire economic life, which had not terminated at the time of the sale. 338 F. 2d at 631. The Eighth Circuit allowed in full the depreciation deductions computed by the taxpayer for the year of sale under the reasonable estimates used for prior years.

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[106] *Harry Trotz*, 43 T. C. 127 (1964), on appeal to Tenth Circuit; compare *C. L. Nichols*, 43 T. C. 135 (1964), on appeal to Eighth Circuit.

[107] *Holder Drive-Ur-Self, Inc.*, 43 T. C. 202 (1964); *Harry Friend*, T. C. Memo. 1965-35, 25 CCH T. C. Memo. 192 (1965), on appeal to Fourth Circuit.

[108] *Palmaneda Adams*, T C. Memo. 1964-286, 23 CCH T. C. Memo. 1743 (1964), on appeal to Sixth Circuit; *Moses Lake Homes, Inc.*, T. C. Memo. 1964-289, 23 CCH T. C. Memo. 1756 (1964), on appeal to Ninth Circuit; *Herschel M. Hays*, T. C. Memo. 1965-213, 25 CCH T. C. Memo. 1103 (1965).

[109] *Engineers Limited Pipeline Co.*, 44 T. C. ——, No. 25 (1965); *L. M. Lockhart*, 43 T. C. 776 (1965), on appeal to Ninth Circuit; *Bell Lines, Inc.*, 43 T. C. 358 (1964); *Specialty Paper and Board Co.*, T. C. Memo. 1965-208, 24 CCH T. C. Memo. 1085 (1965); *The Covered Wagon, Inc.*, T. C. Memo. 1965-79, 24 CCH T. C. Memo. 427 (1965); *Melvon C. Miller*, T. C. Memo. 1964-305, 23 CCH T. C. Memo. 1888 (1964).

[110] *Smith Leasing Co.*, 43 T. C. 37 (1964), on appeal to Fifth Circuit.

In denying the automatic equivalence of sales price with salvage value asserted by the Commissioner, the court said: "Depreciation and capital gain or loss are separate concepts in the income tax law although, of course, the one necessarily affects the other. The former in theory rests on a base independent of market fluctuations. The latter is aimed at those fluctuations. This dichotomy is inherent in the statute. It is defeated and ignored if depreciation is inevitably to be tied to sale price." 338 F. 2d at 641.

The Eighth Circuit, like the Tax Court in *Macabe,* held that the unanticipated sale of depreciable property in the middle of its useful life does not reduce its useful life to the actual holding period and that the sales price of the property does not constitute its salvage value. Salvage value is the amount expected to be realized at the end of useful life, the court held, not any sales price actually obtained. "There is no absolute identity of salvage value with sales price. The one is not necessarily equivalent to the other. Neither the statute nor the regulations equate them or make an exception out of the sale year." 338 F. 2d at 640.

In accord with the Tax Court and the Eighth Circuit, five district courts (in addition to the Minnesota district court affirmed by the Eighth Circuit in the *S & A* case) have rejected the Commissioner's new position and allowed depreciation up to the date of profitable sale or other disposition in cases involving sales of rental automobiles,[111] rental houses,[112] an Air Force housing project,[113] machinery, equipment and buildings used in a milling and feed business,[114] and a gas processing plant and gathering system.[115]

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[111] *Motorlease Corp.* v. *United States, supra* note 102.
[112] *Occidental Loan Co.* v. *United States, supra* note 102.
[113] *Wyoming Builders, Inc.* v. *United States, supra* note 102.
[114] *Mountain States Mixed Feed Co.* v. *United States, supra* note 102.
[115] *Kimball Gas Products Co.* v. *United States, supra* note 102.

The great weight of current judicial authority thus continues to adhere to the traditional view that depreciation is allowable for the year of profitable sale.

V. The Taxpayer Is Entitled to the Reasonable Allowance Claimed by It for Depreciation of the *Feuer*.

The facts in this case are undisputed and the issue is purely one of law.[116] We have shown that, under the correct rule of law, reasonably established salvage value is not subject to change because of changes in market levels. Under this rule, the taxpayer is entitled to the depreciation claimed for the *Feuer* for 1957, because the correctness of the salvage value established for the *Feuer* is uncontroverted.[117]

The essential facts are that the taxpayer owned and operated the *Feuer* in its profitable shipping business. (R. 3.) Against its gross profit of almost $300,000 from operation of the *Feuer* during 1957, the taxpayer deducted about $135,000 for depreciation of the ship. (R. 7.) This depreciation was at the rate established by a ruling letter obtained from the Internal Revenue Service at the time of the taxpayer's purchase of the *Feuer* in 1955. (R. 4.) The taxpayer, receiving an unsolicited attractive offer for the *Feuer* during the Suez Canal crisis, sold it in December 1957 at a substantial profit. (R. 5-6.)

The correctness of the estimate of a three-year useful economic life and a $54,000 salvage value for the *Feuer*

[116]The Commissioner agrees that the sole question is one of law (Respondent's Brief, p. 5, in the Second Circuit in this case) and that the facts are undisputed (*id.* at p. 7).

[117]There is a suggestion in the *Macabe* opinion, *supra,* at 1110-1111, 1115, that the decision below, although unsound in principle, might be justified on the ground that the taxpayer failed to prove that the gain on sale was not attributable to excessive depreciation. This statement reflects a failure to examine the record in this case, which clearly establishes the reasonableness of the taxpayer's estimates of useful life and salvage value.

was established by the ruling letter issued by the Commissioner's expert Engineering and Valuation Branch. (R. 4.) The Tax Court found that the Commissioner had never changed the ruling letter (R. 5) and had never questioned the estimated three-year life. (R. 14.) The Tax Court also summarized in its findings the extensive evidence presented by the taxpayer in support of the correctness of that estimated useful life. (R. 8-10.)

The Tax Court further stated that the taxpayer had presented extensive evidence supporting the correctness at the end of 1957 of the estimated $54,000 salvage value based on scrap prices. (R. 11, 14.) Since the Tax Court found that the taxpayer did not follow the practice of using ships for a short time and then reselling them (R. 6, 14), scrap value was the proper measure of salvage value. *Massey Motors, Inc.* v. *United States, supra* p. 21, at 96. The Tax Court also found that the increase in the market value of the *Feuer* was "due to economic and market conditions" resulting from the Suez Canal crisis (R. 6), and the Second Circuit recognized that "the increment in the *Feuer's* value resulted from a fortuity normally associated with capital gain." (R. 81.)

These undisputed facts show that the taxpayer would be entitled to depreciation in the amount claimed even if this Court were to adopt the view that salvage value could be adjusted to a sales price received "at or near the end of the useful life of the asset."[118] The price received on the unanticipated sale of the *Feuer* in the middle of its useful life sheds no light on the amount of salvage value realizable at the end of its useful life.[119] On expiration of that useful life, the vessel would be obsolete and saleable only for scrap.

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[118] *Cohn* v. *United States,* 259 F. 2d at 378.

[119] See pp. 50 and 52, *supra.*

Since the disallowance of depreciation on the *Feuer* is grounded solely on an erroneous conception of law, the decision below should be reversed. "To remand the cause for further findings would be futile. The Board could not properly find anything which would assist the Commissioner's cause." *General Utilities Co.* v. *Helvering,* 296 U. S. 200, 207 (1935).

CONCLUSION

The decision of the Court of Appeals is erroneous and should be reversed.

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APPENDICES

APPENDIX A

Statutes

SEC. 167.* DEPRECIATION.

(a) General Rule.—There shall be allowed as a depreciation deduction a reasonable allowance for the exhaustion, wear and tear (including a reasonable allowance for obsolescence)—

(1) of property used in the trade or business, or

(2) of property held for the production of income.

(b) Use of Certain Methods and Rates.—For taxable years ending after December 31, 1953, the term "reasonable allowance" as used in subsection (a) shall include (but shall not be limited to) an allowance computed in accordance with regulations prescribed by the Secretary or his delegate, under any of the following methods:

(1) the straight line method. . . .

(f) Basis for Depreciation.—The basis on which exhaustion, wear and tear, and obsolescence are to be allowed in respect of any property shall be the adjusted basis provided in section 1011 for the purpose of determining the gain on the sale or other disposition of such property.

Treasury Regulations

§ 1.167(a)-1. DEPRECIATION IN GENERAL.

(a) *Reasonable allowance.* Section 167 (a) provides that a reasonable allowance for the exhaustion, wear and

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*As in effect during the calendar year 1957. Subsection 167(f) has since been relettered as subsection 167(g).

tear, and obsolescence of property used in the trade or business or of property held by the taxpayer for the production of income shall be allowed as a depreciation deduction. The allowance is that amount which should be set aside for the taxable year in accordance with a reasonably consistent plan (not necessarily at a uniform rate), so that the aggregate of the amounts set aside, plus the salvage value, will, at the end of the estimated useful life of the depreciable property, equal the cost or other basis of the property as provided in section 167(g) and § 1.167(g)-1. An asset shall not be depreciated below a reasonable salvage value under any method of computing depreciation. However, see section 167(f) and § 1.167(f)-1 for rules which permit a reduction in the amount of salvage value to be taken into account for certain personal property acquired after October 16, 1962. See also paragraph (c) of this section for definition of salvage. The allowance shall not reflect amounts representing a mere reduction in market value. See section 179 and § 1.179-1 for a further description of the term "reasonable allowance."

(b) *Useful life.* For the purpose of section 167 the estimated useful life of an asset is not necessarily the useful life inherent in the asset but is the period over which the asset may reasonably be expected to be useful to the taxpayer in his trade or business or in the production of his income. This period shall be determined by reference to his experience with similar property taking into account present conditions and probable future developments. Some of the factors to be considered in determining this period are (1) wear and tear and decay or decline from natural causes, (2) the normal progress of the art, economic changes, inventions, and current developments within the industry and the taxpayer's trade or business, (3) the climatic and other local conditions peculiar to the taxpayer's trade or business, and (4) the taxpayer's policy as to re-

pairs, renewals, and replacements. Salvage value is not a factor for the purpose of determining useful life. If the taxpayer's experience is inadequate, the general experience in the industry may be used until such time as the taxpayer's own experience forms an adequate basis for making the determination. The estimated remaining useful life may be subject to modification by reason of conditions known to exist at the end of the taxable year and shall be redetermined when necessary regardless of the method of computing depreciation. However, estimated remaining useful life shall be redetermined only when the change in the useful life is significant and there is a clear and convincing basis for the redetermination. For rules covering agreements with respect to useful life, see section 167(d) and § 1.167(d)-1.

(c) *Salvage.* (1) Salvage value is the amount (determined at the time of acquisition) which is estimated will be realizable upon sale or other disposition of an asset when it is no longer useful in the taxpayer's trade or business or in the production of his income and is to be retired from service by the taxpayer. Salvage value shall not be changed at any time after the determination made at the time of acquisition merely because of changes in price levels. However, if there is a redetermination of useful life under the rules of paragraph (b) of this section, salvage value may be redetermined based upon facts known at the time of such redetermination of useful life. Salvage, when reduced by the cost of removal, is referred to as net salvage. The time at which an asset is retired from service may vary according to the policy of the taxpayer. If the taxpayer's policy is to dispose of assets which are still in good operating condition, the salvage value may represent a relatively large proportion of the original basis of the asset. However, if the taxpayer customarily uses an asset until its inherent useful life has been substantially ex-

hausted, salvage value may represent no more than junk value. Salvage value must be taken into account in determining the depreciation deduction either by a reduction of the amount subject to depreciation or by a reduction in the rate of depreciation, but in no event shall an asset (or an account) be depreciated below a reasonable salvage value. See, however, paragraph (a) of § 1.167(b)-2 for the treatment of salvage under the declining balance method, and § 1.179-1 for the treatment of salvage in computing the additional first-year depreciation allowance. The taxpayer may use either salvage or net salvage in determining depreciation allowances but such practice must be consistently followed and the treatment of the costs of removal must be consistent with the practice adopted. For specific treatment of salvage value, see §§ 1.167(b)-1, 1.167(b)-2, and 1.167(b)-3. When an asset is retired or disposed of, appropriate adjustments shall be made in the asset and depreciation reserve accounts. For example, the amount of the salvage adjusted for the costs of removal may be credited to the depreciation reserve.

(2) For taxable years beginning after December 31, 1961, and ending after October 16, 1962, see section 167(f) and § 1.167(f)-1 for rules applicable to the reduction of salvage value taken into account for certain personal property acquired after October 16, 1962.

§ 1.167(a)-8. Retirements. (a) *Gains and losses on retirements.* For the purposes of this section the term "retirement" means the permanent withdrawal of depreciable property from use in the trade or business or in the production of income. The withdrawal may be made in one of several ways. For example, the withdrawal may be made by selling or exchanging the asset, or by actual abandonment. In addition, the asset may be withdrawn from such productive use without disposition as, for example, by being

placed in a supplies or scrap account. The tax consequences of a retirement depend upon the form of the transaction, the reason therefor, the timing of the retirement, the estimated useful life used in computing depreciation, and whether the asset is accounted for in a separate or multiple asset account. Upon the retirement of assets, the rules in this section apply in determining whether gain or loss will be recognized, the amount of such gain or loss, and the basis for determining gain or loss:

(1) Where an asset is retired by sale at arm's length, recognition of gain or loss will be subject to the provisions of sections 1002, 1231, and other applicable provisions of law.

(2) Where an asset is retired by exchange, the recognition of gain or loss will be subject to the provisions of sections 1002, 1031, 1231, and other applicable provisions of law.

(3) Where an asset is permanently retired from use in the trade or business or in the production of income but is not disposed of by the taxpayer or physically abandoned (as, for example, when the asset is transferred to a supplies or scrap account), gain will not be recognized. In such a case loss will be recognized measured by the excess of the adjusted basis of the asset at the time of retirement over the estimated salvage value or over the fair market value at the time of such retirement if greater, but only if—

(i) The retirement is an abnormal retirement, or

(ii) The retirement is a normal retirement from a single asset account (but see paragraph (d) of this section for special rule for item accounts), or

(iii) The retirement is a normal retirement from a multiple asset account in which the depreciation rate was

based on the maximum expected life of the longest lived asset contained in the account.

(4) Where an asset is retired by actual physical abandonment (as, for example, in the case of a building condemned as unfit for further occupancy or other use), loss will be recognized measured by the amount of the adjusted basis of the asset abandoned at the time of such abandonment. In order to qualify for the recognition of loss from physical abandonment, the intent of the taxpayer must be irrevocably to discard the asset so that it will neither be used again by him nor retrieved by him for sale, exchange, or other disposition.

Experience with assets which have attained an exceptional or unusual age shall, with respect to similar assets, be disregarded in determining the maximum expected useful life of the longest lived asset in a multiple asset account. For example, if a manufacturer establishes a proper multiple asset account for 50 assets which are expected to have an average life of 30 years but which will remain useful to him for varying periods between 20 and 40 years, the maximum expected useful life will be 40 years, even though an occasional asset of this kind may last 60 years.

(b) *Definition of normal and abnormal retirements.* For the purpose of this section the determination of whether a retirement is normal or abnormal shall be made in the light of all the facts and circumstances. In general, a retirement shall be considered a normal retirement unless the taxpayer can show that the withdrawal of the asset was due to a cause not contemplated in setting the applicable depreciation rate. For example, a retirement is considered normal if made within the range of years taken into consideration in fixing the depreciation rate and if the asset has reached a condition at which, in the normal course of events,

the taxpayer customarily retires similar assets from use in his business. On the other hand, a retirement may be abnormal if the asset is withdrawn at an earlier time or under other circumstances, as, for example, when the asset has been damaged by casualty or has lost its usefulness suddenly as the result of extraordinary obsolescence.

(c) *Basis of assets retired.* The basis of an asset at the time of retirement for computing gain or loss shall be its adjusted basis for determining gain or loss upon a sale or other disposition as determined in accordance with the provisions of section 1011 and the following rules:

(1) In the case of a normal retirement of an asset from a multiple asset account where the depreciation rate is based on average expected useful life, the term "adjusted basis" means the salvage value estimated in determining the depreciation deduction in accordance with the provisions in paragraph (c) of § 1.167(a)-1.

(2) In the case of a normal retirement of an asset from a multiple asset account in which the depreciation rate was based on the maximum expected life of the longest lived asset in the account, the adjustment for depreciation allowed or allowable shall be made at the rate which would have been proper if the asset had been depreciated in a single asset account (under the method of depreciation used for the multiple asset account) using a rate based upon the maximum expected useful life of that asset, and

(3) In the case of an abnormal retirement from a multiple asset account the adjustment for depreciation allowed or allowable shall be made at the rate which would have been proper had the asset been depreciated in a single asset account (under the method of depreciation used for the multiple asset account) and using a rate based upon either the average expected useful life or the maximum

expected useful life of the asset, depending upon the method of determining the rate of depreciation used in connection with the multiple asset account.

. . . .

§ 1.167(a)-9. OBSOLESCENCE. The depreciation allowance includes an allowance for normal obsolescence which should be taken into account to the extent that the expected useful life of property will be shortened by reason thereof. Obsolescence may render an asset economically useless to the taxpayer regardless of its physical condition. Obsolescence is attributable to many causes, including technological improvements and reasonably foreseeable economic changes. Among these causes are normal progress of the arts and sciences, supersession or inadequacy brought about by developments in the industry, products, methods, markets, sources of supply, and other like changes, and legislative or regulatory action. In any case in which the taxpayer shows that the estimated useful life previously used should be shortened by reason of obsolescence greater than had been assumed in computing such estimated useful life, a change to a new and shorter estimated useful life computed in accordance with such showing will be permitted. No such change will be permitted merely because in the unsupported opinion of the taxpayer the property may become obsolete. For rules governing the allowance of a loss when the usefulness of depreciable property is suddenly terminated, see § 1.167(a)-8. If the estimated useful life and the depreciation rates have been the subject of a previous agreement, see section 167(d) and § 1.167(d)-1.

§ 1.167(a)-10. WHEN DEPRECIATION DEDUCTION IS ALLOWABLE. (a) A taxpayer should deduct the proper depreciation allowance each year and may not increase his depreciation allowances in later years by reason of his

failure to deduct any depreciation allowance or of his action in deducting an allowance plainly inadequate under the known facts in prior years. The inadequacy of the depreciation allowance for property in prior years shall be determined on the basis of the allowable method of depreciation used by the taxpayer for such property or under the straight line method if no allowance has ever been claimed for such property. The preceding sentence shall not be construed as precluding application of any method provided in section 167 (b) if taxpayer's failure to claim any allowance for depreciation was due solely to erroneously treating as a deductible expense an item properly chargeable to capital account. For rules relating to adjustments to basis, see section 1016 and the regulations thereunder.

(b) The period for depreciation of an asset shall begin when the asset is placed in service and shall end when the asset is retired from service. A proportionate part of one year's depreciation is allowable for that part of the first and last year during which the asset was in service. However, in the case of a multiple asset account, the amount of depreciation may be determined by using what is commonly described as an "averaging convention" that is, by using an assumed timing of additions and retirements. For example, it might be assumed that all additions and retirements to the asset account occur uniformly throughout the taxable year, in which case depreciation is computed on the average of the beginning and ending balances of the asset account for the taxable year. See example (3) under paragraph (b) of § 1.167(b)-1. Among still other averaging conventions which may be used is the one under which it is assumed that all additions and retirements during the first half of a given year were made on the first day of that year and that all additions and retirements during the second half of the year were made on the first day of the following year. Thus, a full year's depreciation would be

taken on additions in the first half of the year and no depreciation would be taken on additions in the second half. Moreover, under this convention, no depreciation would be taken on retirements in the first half of the year and a full year's depreciation would be taken on the retirements in the second half. An averaging convention, if used, must be consistently followed as to the account or accounts for which it is adopted, and must be applied to both additions and retirements. In any year in which an averaging convention substantially distorts the depreciation allowance for the taxable year, it may not be used.

§1.167(b)-0. METHODS OF COMPUTING DEPRECIATION. (a) *In general.* Any reasonable and consistently applied method of computing depreciation may be used or continued in use under section 167. Regardless of the method used in computing depreciation, deductions for depreciation shall not exceed such amounts as may be necessary to recover the unrecovered cost or other basis less salvage during the remaining useful life of the property. The reasonableness of any claim for depreciation shall be determined upon the basis of conditions known to exist at the end of the period for which the return is made. It is the responsibility of the taxpayer to establish the reasonableness of the deduction for depreciation claimed. Generally, depreciation deductions so claimed will be changed only where there is a clear and convincing basis for a change.

(b) *Certain methods.* Methods previously found adequate to produce a reasonable allowance under the Internal Revenue Code of 1939 or prior revenue laws will, if used consistently by the taxpayer, continue to be acceptable under section 167(a). Examples of such methods which continue to be acceptable are the straight line method, the declining balance method with the rate limited to 150 percent of the applicable straight line rate, and under appropriate circum-

stances, the unit of production method. The methods described in section 167(b) and §§ 1.167(b)-1, 1.167(b)-2, 1.167(b)-3, and 1.167(b)-4 shall be deemed to produce a reasonable allowance for depreciation except as limited under section 167(c) and § 1.167(c)-1. See also § 1.167(e)-1 for rules relating to change in method of computing depreciation.

. . . .

§ 1.167(b)-1. STRAIGHT LINE METHOD. (a) *Application of method.* Under the straight line method the cost or other basis of the property less its estimated salvage value is deductible in equal annual amounts over the period of the estimated useful life of the property. The allowance for depreciation for the taxable year is determined by dividing the adjusted basis of the property at the beginning of the taxable year, less salvage value, by the remaining useful life of the property at such time. For convenience, the allowance so determined may be reduced to a percentage or fraction. The straight line method may be used in determining a reasonable allowance for depreciation for any property which is subject to depreciation under section 167 and it shall be used in all cases where the taxpayer has not adopted a different acceptable method with respect to such property.

. . . .

§ 1.167(g)-1. BASIS FOR DEPRECIATION. The basis upon which the allowance for depreciation is to be computed with respect to any property shall be the adjusted basis provided in section 1011 for the purpose of determining gain on the sale or other disposition of such property. In the case of property which has not been used in the trade or business or held for the production of income and which is thereafter converted to such use, the fair market value on the date of such conversion, if less than the adjusted basis of the property at that time, is the basis for computing depreciation.

APPENDIX B

Statutory Depreciation Provisions, 1909-1965

CORPORATION EXCISE TAX ACT OF 1909.

SEC. 38 (SECOND).

Such net income shall be ascertained by deducting from the gross amount of the income . . . a reasonable allowance for depreciation of property, if any . . . .

REVENUE ACT OF 1913.

Sec. IIB (individuals).

[I]n computing net income for the purpose of the normal tax there shall be allowed as deductions . . . a reasonable allowance for the exhaustion, wear and tear of property arising out of its use or employment in the business . . . .

Sec. IIG (corporations).

[N]et income shall be ascertained by deducting from the gross amount of the income . . . a reasonable allowance for depreciation by use, wear and tear of property, if any . . . .

REVENUE ACT OF 1916.

Sec. 5(a) (individuals).

[I]n computing net income . . . there shall be allowed as deductions . . . A reasonable allowance for the exhaustion, wear and tear of property arising out of its use or employment in the business or trade . . . .

Sec. 12(a) (corporations).

[N]et income shall be ascertained by deducting from the gross amount of its income . . . a reasonable allowance for the exhaustion, wear and tear of property arising out of its use or employment in the business or trade . . . .

Revenue Act of 1918.

Sec. 214(a)(8) (individuals).

[I]n computing net income there shall be allowed as deductions . . . A reasonable allowance for the exhaustion, wear and tear of property used in the trade or business, including a reasonable allowance for obsolescence . . . .

Sec. 234(a)(7) (corporations).

[I]n computing the net income . . . there shall be allowed as deductions . . . A reasonable allowance for the exhaustion, wear and tear of property used in the trade or business, including a reasonable allowance for obsolescence . . . .

Revenue Act of 1921, Sec. 214(a)(8) (individuals) and Sec. 234(a)(7) (corporations).

Same as Revenue Act of 1918, Sec. 214(a)(8) and Sec. 234(a)(7).

Revenue Act of 1924, Sec. 214(a)(8) (individuals) and Sec. 234(a)(7) (corporations).

Same as Revenue Act of 1918, Sec. 214(a)(8) and Sec. 234(a)(7).

Revenue Act of 1926, Sec. 214(a)(8) (individuals) and Sec. 234(a)(7) (corporations).

Same as Revenue Act of 1918, Sec. 214(a)(8) and Sec. 234(a)(7).

Revenue Act of 1928, Sec. 23(k).

In computing net income there shall be allowed as deductions . . . A reasonable allowance for the exhaustion, wear and tear of property used in the trade or business, including a reasonable allowance for obsolescence . . . .

Revenue Act of 1932, Sec 23(k).
Same as Revenue Act of 1928, Sec. 23(k).

Revenue Act of 1934, Sec. 23(l).
Same as Revenue Act of 1928, Sec. 23(k).

Revenue Act of 1936, Sec. 23(l).
Same as Revenue Act of 1928, Sec. 23(k).

Revenue Act of 1938, Sec. 23(l).
Same as Revenue Act of 1928, Sec. 23(k).

Internal Revenue Code of 1939, Sec. 23(l), as originally enacted.
Same as Revenue Act of 1928, Sec. 23(k).

Internal Revenue Code of 1939, Sec. 23(l), as retroactively amended by Revenue Act of 1942, Sec. 121(c).

In computing net income there shall be allowed as deductions . . . A reasonable allowance for the exhaustion, wear and tear (including a reasonable allowance for obsolescence)—

(1) of property used in the trade or business, or

(2) of property held for productions of income.

Internal Revenue Code of 1954, Sec. 167(a).
See Appendix A, p. 1a, *supra*.